S. HRG. 99-227

MORGAN STANLEY PROPOSAL

HEARING

BEFORE THE

COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

ON

MORGAN STANLEY PROPOSAL TO PURCHASE CONRAIL

JUNE 12, 1985

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MORGAN STANLEY PROPOSAL

WEDNESDAY, JUNE 12, 1985

U.S. SENATE,
COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION,
Washington, DC.

The committee met, pursuant to notice, at 2:06 p.m., in room SR-253, Hon. John C. Danforth (chairman of the committee) presiding.

Staff members assigned to this hearing: Pamela Garvie, staff counsel; Linda Morgan, minority staff counsel; and Steve Palmer, minority professional staff member.

OPENING STATEMENT BY THE CHAIRMAN

The CHAIRMAN. On April 30 the Commerce Committee ordered favorably reported S. 638, a bill that was introduced by myself and Senator Hollings to implement the sale of Conrail to Norfolk Southern. The committee's action followed 3 days of long hearings, during which we examined the Norfolk Southern proposal as well as the feasibility and desirability of selling Conrail by means of a public offering. Currently I am seeking floor time for S. 638.

In mid-May Morgan Stanley announced that it had put together a new public offering proposal. Because I expect questions to be raised about the Morgan Stanley proposal when S. 638 is brought up, I scheduled today's hearing to review the proposal.

I have asked the witnesses to comment on the details of the proposal, its viability, how it compares to the Norfolk Southern plan. We also asked for information about the investors.

Let me say this in general first. Every time we have a hearing or when we had the markup of this bill, one of the things asked is, why are we rushing? I mean, that is automatic, somebody has scripted that question, why are we rushing? We are not rushing. We are moving like people pushing a huge rock up a mountain.

This has been the slowest proceeding I can imagine. This has been going on since 1981. It has been elaborately discussed. My own feeling is the time has come to get on with it. If it is a good idea for Conrail to be operated by somebody other than the Federal Government, I think we should get on with it.

I do not think we can continue to keep the process open forever. However, I have great respect for Morgan Stanley and I know that it is a very, very serious, competent firm, and I think that any proposal deserves analysis and consideration, and that is what we are giving it today.

I think that the basic decision for Congress to make is, what is in the best interests of rail transportation in the Northeast part of

our country. I have never believed that the primary consideration should be how much money is Uncle Sam going to get.

Now, it turns out it is going to get the same under both proposals. Morgan Stanley believes that the tax loss to the Federal Government would be considerable in the Norfolk Southern transaction. Other people disagree with that. It is debatable.

But I have never believed that it is primarily a question of cash. It seems to me that the issue is one of long-term health of rail transportation in the Northeast part of our country. One of the questions is, should Conrail be affiliated with the Norfolk Southern as part of that system or should it be a stand-alone railroad. That is one of the issues that has been raised by the Morgan Stanley proposal.

CSX has previously said that it does not believe that Conrail could survive as a stand-alone railroad. Now it turns out CSX is part of the consortium that has been put together to acquire Conrail. But that is a very basic question: Is it healthier as a stand-alone railroad, contrary to the advice of CSX itself, or should it be affiliated with somebody else?

How about the cash requirements? You know, it is interesting. This morning we had a hearing on TWA and the Carl Icahn proposal, and one of the questions there, I guess the basic question, is well, what is the commitment to the airline? If you have an airline that is taken over by somebody who is basically interested in generating cash or interested in selling assets possibly for cash, what is the future of the airline itself?

I think there is a parallel consideration here. If investors are interested in generating cash—and a part of the deal as I understand it is a very substantial return on their investment, something like an 8.4-percent return on their investment—and they are looking at that cash generation, what is their commitment to the future of the railroad, and what is going to happen if the railroad gets into trouble? And can any railroad produce that kind of cash for shareholders without getting itself in big trouble?

I think those are some of the concerns. But again, the general concern that I have is, what is going to produce the healthiest railroad, the healthiest Conrail, in the long run.

Does any other Senator have a statement? Senator Hollings? Senator Long? Senator Gore?

OPENING STATEMENT BY SENATOR GORE

Senator GORE. Mr. Chairman, I would ask unanimous consent to put a statement in the record.

Mr. Chairman, I want to thank you and Senator Hollings for agreeing to hold this hearing. I know there is tremendous pressure to expeditiously move the DOT plan to sell Conrail to Norfolk Southern—a plan I supported in the markup earlier this year.

But I strongly believe that the sale of the Government's interest in Conrail deserves all possible attention, especially when new information is presented. The Morgan Stanley offer before us today is such new information, and I am looking forward to closely scrutinizing the plan.

When we considered the DOT plan in April, there appeared to be only two alternatives—accept the Norfolk Southern bid * * * or do nothing. So we voted to report the DOT plan by a substantial margin, and I was among the majority who supported that proposal.

I believed then, as I do now, that there are still serious antitrust questions that remain unanswered in the DOT plan. I would hope that the Judiciary Committee review, and full debate on the Senate floor, will resolve those outstanding issues.

And, I believe that this new Morgan Stanley plan is not without merit. I am intrigued by the suggestion by the Morgan Stanley advocates that this plan not only solves all the anticompetition problems and labor issues, but also amounts to a better return to the taxpayer for the Federal Government's enormous investment in Conrail.

Although I supported the Norfolk Southern bid during our markup in April, I have an open mind on the Morgan Stanley plan. If, as its supporters claim, it is a much better deal for rail workers, shippers, communities which rely on rail freight service, and the taxpayers, then by all means we should reconsider our earlier vote when the issue comes to the Senate floor.

If, on the other hand, there are serious flaws, misstatements, illusory accounting claims, and/or other problems in the Morgan Stanley plan, we should clearly reject it and take the Norfolk Southern bid to the floor debate.

But Mr. Chairman, I want to reiterate my complete opposition to limiting full Senate consideration of the DOT plan to a few frantic minutes during debate over the first budget resolution and reconciliation. The other 83 Senators not on this committee deserve a broader airing of this plan—a measure which will forever change the nature of rail freight service in our country. Again, I urge you to withstand the pressure to simply ram the DOT plan through the Senate as part of budget reconciliation.

On a more positive note, I want to sincerely thank you and Senator Hollings for your overall leadership on this issue, and for agreeing to hold this hearing.

The CHAIRMAN. Senator Rockefeller.

OPENING STATEMENT BY SENATOR ROCKEFELLER

Senator ROCKEFELLER. Mr. Chairman, I will just make one comment and put a statement in the record, if that is all right. As you know, I did not vote for the Department of Transportation's proposal, because I did not—because I had, after looking at it very carefully, substantial doubts as to its long-term effect on West Virginia. And I also realized that one cannot vote no all the time.

We have now before us a new proposal. I simply want to say that I am going to look at that very, very closely. And I, as you, want to be sure that the public interest is served. I think the questions you raise as to the profit profile, dividend arrangements, et cetera, are crucial. What are the chances for long-term viability under this type of arrangement?

I think those questions have to be asked and answered specifically. But I do look upon it as an interesting alternative at the

moment, and I plan to question it closely, look at it closely. And I hope that, whatever happens, we will come out of this with a resolution to Conrail's future which will help us somehow in the East and in my own State of West Virginia look at long-term industrial development, commercial developments.

I come from a State where the economy needs not only stability, but a boost, and I am going to do my best to see that it gets it.

Mr. Chairman, I greatly appreciate the opportunity that the committee has today to hear from such a distinguished group of witnesses. I commend the chairman for his efforts to hold this hearing and I am looking forward to learning a great deal from the witnesses.

Mr. Chairman, when the committee considered S. 638, the legislation reflecting Secretary Dole's recommendation to sell Conrail to the Norfolk Southern Corp., I voted against the legislation. I did so because I had serious doubts about whether West Virginians would see an improved level of competition or service as a result of the sale.

As those of us in public life know well, we do not have the luxury of always voting no on an issue; we have a responsibility to seek constructive alternatives. With regard to the sale of Conrail, I believe it is incumbent upon this committee and the Senate to give all serious proposals a proper and fair hearing.

Mr. Chairman, although I have not decided whether the proposal by Morgan Stanley satisfies all of my concerns about the sale of Conrail, I do view it as a helpful and positive addition to the debate. I intend to give the Morgan Stanley proposal the same critical evaluation I have given the Department of Transportation's recommendation. But I want to be assured that my State of West Virginia, whose coal based economy is so heavily dependent on our ability to move products by rail, will realize at least the same, if not an improved level of competition and service.

Moreover, I want to be assured that the public interest factors we all deem important will be met:

—assured that the hard work and management excellence that has gone into making Conrail an aggressive competitor and a railroad that offers competitive rates and quality service will last;

—assured that we are putting in place a structure for Conrail that will keep Conrail a viable rail carrier in the long term;

—assured that the financial arrangements, future public offerings by Morgan Stanley, dividend arrangement, profit profile, et cetera, are consistent with a continued effort to improve the railroad.

Mr. Chairman, I think the debate on Conrail has been a healthy one. I think it has focused our attention on the necessity of a viable and competitive rail system in the Eastern United States. I have hoped that it would lead not only to a resolution of Conrail's future but to a renewed commitment by all railroads that serve the East to improve service and increase efforts at industrial and commercial development, especially in the State of West Virginia, where the economy badly needs a boost.

Mr. Chairman, I look forward to participating in today's hearing.

The CHAIRMAN. Senator Gorton.

OPENING STATEMENT BY SENATOR GORTON

Senator GORTON. Mr. Chairman, I am not going to be able to stay for this hearing because of the conference on the budget. But I came at this point to show my interest in this proposition.

I am not wedded to any course of action with respect to Conrail, other than that it be divested from Government ownership as soon as possible. And I think it is appropriate that you have called this hearing for the reasons which you have outlined, and I believe that we should give careful consideration to this alternative in order to determine whether in fact it is equal to or superior to that of the one which has been reported before.

Mr. Chairman, I would like, because I must leave, I would like an opportunity to have some questions in the record submitted to some or all of the witnesses.

The CHAIRMAN. OK, fine.

Anybody else?

OPENING STATEMENT BY SENATOR PRESSLER

Senator PRESSLER. Mr. Chairman, I have a statement. This morning someone from the Hill sent me a Chicago North Western hat and told me to wear it while I was speaking. But I'm not speaking only for Chicago North Western; I am speaking for my views and the United States, and I am not taking a provincial view of this thing.

But I do want to highlight that my major concern in this issue is to see that the smaller Midwest and other regional railroads are protected from a truly monopolistic railroad in the East. This is not just a Northeast or an east coast problem. It encompasses the entire country and goes much further than simply threatening the markets of other railroads.

It could result in serious anticompetitive problems, real problems that translate into dollars and cents for every consumer in the country. This anticompetitive problem is the single largest concern of mine. I will discuss it in more detail in just 1 minute.

But I do want to touch upon other areas of concern that the Morgan Stanley proposal addresses. I am pleased that we now have a proposal for a public offering from Morgan Stanley. There are many questions to be asked of Morgan Stanley, but I believe we must have an alternative to the Norfolk Southern proposal if we are to return Conrail to the private sector.

And let me say that I share that objective of returning Conrail to the private sector. I commend the Secretary of Transportation for all her work, and her staff, in focusing the issues concerning Conrail. Conrail should be returned to the private sector, but not in a way that does extreme violence to our national transportation system.

A sale of Conrail to Norfolk Southern would endanger the basic framework of our transportation system. There are many reasons for saying this and let me indicate just a few. First of all, valuation and tax implications. I am concerned that we still do not know the true value of the Norfolk Southern proposal to the Federal Government or how it compares to the Morgan Stanley proposal.

As we are all aware, the Congressional Budget Office has completed an analysis of S. 638, which provides for a sale to Norfolk Southern. CBO estimates that the sale would bring in $1.4 billion, which is the Norfolk Southern bid, plus the excess cash. But it also estimates the Government would lose approximately $0.4 billion in tax revenues and $0.8 billion in interest and dividends.

There are adjustments that would have to be made for the time value of money, but even with these adjustments it is clear that a considerable sum is lost in tax revenues and the net gain to the Government of the sale to the Norfolk Southern is not very large.

Although Norfolk Southern has insisted the tax loss is much smaller, they have stated several times that they would not accept a legislative provision that would bar them from using Conrail tax benefits for the Norfolk Southern. I find this is a totally unsatisfactory response on the part of the Norfolk Southern, and before we can evaluate the two proposals we have DOT's commitment to Norfolk Southern that Norfolk Southern will not be able to use the Conrail depreciation or, if they do, they will be required to pay the Government for its use.

Second is the issue of Conrail viability. Much has been made about the viability of Conrail. To me, the list of over 30 of the most sophisticated financial analysts and investor groups in this country says all that needs to be said about the viability of a stand-alone Conrail. I am quite sure that this administration does not want to be sounding like an Orwellian big brother, telling investors what is wise to buy and what is not. But it appears to me that we are coming very close.

Viability is an important question, but it is an important question for either Norfolk Southern or Morgan Stanley. Some would argue that if Conrail ever sees bad times it is better to have the deep pockets of the Norfolk Southern. I am troubled by this theory, for it assumes that Norfolk Southern will continue to fund Conrail "in sickness or in health," and I believe the history of Norfolk Southern is more one of divorce than fidelity. Norfolk Southern agreed at one time to buy the D&H and the Erie Lackawana. Later Norfolk Southern decided they did not fit into its system, and after taking all the tax benefits from these two lines through a holding company called Dereco, it allowed both to wither away. What then happens to Conrail after 5 years out if Conrail or part of Conrail sours? Will Norfolk Southern allow it to wither in a fashion similar to the Erie?

This is my biggest problem with the Norfolk Southern offer. A sale to Norfolk Southern would be terribly anticompetitive. The Justice Department concluded that it would be anticompetitive, and Norfolk Southern has recognized this by asking for a special exemption from the antitrust laws. Justice has attempted to cure the problem by requiring the divestitures of certain lines to smaller regional carriers, Guilford and P&LE. But no one has presented any convincing evidence that these carriers can provide any real competition to what all agree will be a mega-carrier of historic proportions. P&LE and Guilford together made less than $1 million last year, and a combined Norfolk Southern and Conrail made about $1 billion. Those do not seem to be good odds.

We do not yet have the benefit of the Justice analysis of Guilford and P&LE, but there are indications that the situation may be far worse than the picture painted so far. The B&O has testified that it would have to abandon large segments of its routes that now compete with Conrail. The C&NW and the ICG have also indicated that they would be adversely impacted.

But the anticompetitive problems go much further than this. I have recently asked for some documents which I believe illustrate this problem quite well. First let me provide some background. Approximately 1 month ago I was informed of another merger proceeding before the ICC in which the Department of Justice was participating. The case involved the Southern Pacific and Santa Fe Railroads.

I am told the Justice Department and its witness Dr. Pittman are using a fairly standard methodology to review the Southern Pacific-Santa Fe merger, which means that they are using a standard model, as it were, to evaluate a merger in terms of its antitrust implications. The problem is that the Pittman methodology, the methodology they are using in the Santa Fe case and approach, is quite different from the approach used by the Justice Department in the Conrail review.

They are using two different standards at the same time, one in the Santa Fe case and one in Conrail. Not only is the approach different, but the result is dramatically different.

Last month I asked the Justice Department to analyze the anticompetitive impact of Norfolk Southern's proposal using the same analysis in Conrail that it did in the Southern Pacific-Santa Fe case. We have not received an answer yet, but when we do I would like it to be made part of the hearing record.

[The letters follow:]

U.S. SENATE,
COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION,
Washington, DC, May 15, 1985.

Hon. EDWIN MEESE,
The Attorney General,
Washington, DC.

DEAR MR. ATTORNEY GENERAL: As you know, the legal process now being followed to transfer Conrail to the private sector precludes approval of the sale by the Interstate Commerce Commission. In lieu of that approval, the law provides that Congress review and approve the final sale. As a member of the Senate Commerce Committee to which this legislation was referred, I have endeavored to devote a significant amount of time and effort to insuring that this transaction is given consideration commensurate with its importance.

In this regard, I have recently reviewed the study undertaken by Dr. Russell W. Pittman of the U.S. Department of Justice on the competitive effects of the proposed merger between the Atcheson, Topeka and Santa Fe Railroad (ATSF) and the Southern Pacific Railroad (SP). In his March 21, 1985 verified statement before the Interstate Commerce Commission, Dr. Pittman presented some 250 pages of statistical tables highlighting origins, destinations, market pairs and commodities that could potentially suffer competitive harm as a result of an ATSF/SP merger. Prior to presenting those tables, he discussed his methodology, and in particular the "analytical paradigm used in the U.S. Department of Justice Merger Guidelines."

I would like to know if the U.S. Department of Justice used the Pittman methodology in identifying the competitive impact of a Norfolk Southern/Conrail merger? If so, are those findings available for review in a format similar to that used in the ATSF/SP proceeding before the ICC?

If the Pittman methodology was not used, would the Department of Justice be willing to apply that methodology to the appropriate data base so the Congress

might have the benefit of reviewing the Norfolk Southern/Conrail merger on the same basis that the Justice Department is reviewing the ATSF/SP merger?

I understand that in applying that methodology you may be limited to using the ICC Waybill Sample as opposed to the expanded 10 percent sample used in the ATSF/SP case. However, I also understand this will not materially change the outcome of the analysis, nor detract from the relationship between the two sets of data.

Because Congress, and in particular the Commerce Committees, are charged with reviewing this important transaction, I want to ensure that review is as thorough, comprehensive and responsible as possible. In light of that fact, and because we may be debating this issue on the Senate floor yet this month, I hope you will be able to respond to my request before we proceed. Please feel free to contact me if you have any questions or have your staff call Kevin Schieffer of my office at 224-5842. Thank you for your assistance.

Sincerely,

LARRY PRESSLER, *U.S. Senator.*

U.S. DEPARTMENT OF JUSTICE,
ANTITRUST DIVISION,
Washington, DC, August 30, 1985.

Hon. LARRY PRESSLER,
U.S. Senate,
Washington, DC.

DEAR SENATOR PRESSLER: This letter responds to your letters of May 15 and August 2. 1985. In those letters, you asked whether the Department of Justice has analyzed the potential competitive impact of the proposed acquisition of Consolidated Rail Corporation ("Conrail") by Norfolk Southern Corporation ("NS") using the same methodology employed by Dr. Russell W. Pittman in preparing the Department's analysis of the proposed Atchison, Topeka & Santa Fe/Southern Pacific ("Santa Fe/SP") merger.

The Department's attorneys and economists analyzed both proposed mergers using methodologies that applied the principles and framework of the Department's Merger Guidelines to the unique characteristics of the railroad industry. While there were minor differences in the manner in which the Guidelines were applied to each transaction, the same fundamental analytical principles were followed in both cases. The differences arose largely because of the differences in the nature of the two mergers and the contexts in which the Department reviewed them and, to a lesser degree, simply because two different economic experts were involved in the two matters.

As we point out below, the differences in methodology were minor. Although the amount of so-called "problem revenues" identified in the NS/Conrail merger might have been somewhat larger under Dr. Pittman's application of the Guidelines, our conclusions and recommendations would not have differed under either approach. The difference in problem revenues could occur because in analyzing the Santa Fe/SP merger, Dr. Pittman used Business Economic Areas ("BEAs") as the location component of his market definitions. In comparison, the staff economist in the NS/Conrail investigation used 4-digit Standard Point Location Codes ("SPLCs")—generally counties—as the relevant geographic measurement. Four-digit SPLCs are the geographic units that have been used by Department economists in all recent railroad merger proceedings at the Interstate Commerce Commission, except for the Santa Fe/SP merger. Because BEAs are often much larger than counties, it is likely that the total transportation revenues involved in the Santa Fe-SP analysis are larger than they would have been had 4-digit SPLCs had been used. On the other hand, the screens used in both analyses had the same objective—i.e., to identify potential competitive problems in the rail transportation industry.

We describe below the other specific differences between the NS/Conrail and Santa Fe/SP methodologies and the reasons for those differences. We have not, however, replicated the NS/Conrail analysis along precisely the lines employed in Santa Fe/SP as you have requested, because to do so would require an undertaking of several months' work by the same Department staff members who are now heavily engaged in evaluating the viability of the proposed diverstiture by NS to Guilford Transportation Industries and the Pittsburgh & Lake Erie Railroad. Given the insignificant difference in methodology and the overwhelming likelihood that the same conclusions and recommendations would result under either approach, there is no reason to believe that redoing our analysis of the NS/Conrail merger would yield useful results.

1. MONOPOLY-LEG SCREEN

One difference between the NS/Conrail methodology and the Santa Fe/SP methodology was the use in the NS/Conrail analysis of the so-called "monopoly-leg screen." In the NS/Conrail merger, there are a number of markets in which both of the merging railroads provide an interline service with a third railroad that is either the only carrier with a station in the relevant county (see Appendix 1 enclosed herewith) or is the only one that carried all of the relevant commodity to or from the relevant county in 1983 (see Appendix 2).

In analyzing the NS/Conrail merger, these movements were screened out by the "monopoly-leg" screen because, for each movement between any given origin and destination, there is a single monopoly price that will maximize the profits of the carrier or carriers that participate in the move. Competition among railraods along one leg of a given move will not reduce the total cost to shippers below this monopoly price if, along another leg essential to the move, there is a monopoly carrier that is free to charge as much as it pleases. Thus, maintaining competition along one leg provides no material benefit to shippers if they still must rely on a monopolist alongsome other significant leg to deliver or originate their products.

Notwithstanding these considerations, there is one situation in which shippers conceivably could be made worse off in markets with an existing monopoly leg. Such a result could occur if the only two railroads that compete with one another along a connecting leg merge and create a price-increasing (and efficiency-reducing) "successive monopoly" problem. The successive monopoly problem could occur if the resulting two interlining monopolists were unable to reach an agreement that would maximize their joint profits after the merger by charging shippers the original monopoly price for the move and then dividing the monopoly profits between themselves. This was a concern in the Santa Fe/SP merger. As Appendices 1 and 2 show, however, only rarely is it the case in the NS/Conrail merger that in markets that were removed from consideration by the monopoly leg screen the combined NS/Conrail share on the competitive leg of the movement was anywhere near 100 percent of the traffic. Thus, had our analysis of the NS/Conrail merger included among potential problem markets those markets in which a successive monopoly problem was a possibility worth considering more fully, our overall findings would have been affected in only a very minor way. Moreover, even in those markets in which the NS/Conrail merger would result in NS/Conrail carrying all or substantially all of the traffic on a connecting leg, virtually all of the relevant commodities are shipped to a significant degree by transportation modes other than railroads. The existence of such competitive alternatives to rail transportation would further reduce any adverse effects on competition that might occur even though the merger might create a successive railroad monopoly.

2. EXCLUSIVELY SERVED MARKETS

In addition to beginning their respective analyses with a 50/10 screen, both Dr. Pittman and the NS/Conrail staff identified those geographic areas (BEAs in Santa Fe/SP, and counties in NS/Conrail) in which both of the merging entities, but no other railroad, operated stations. This additional procedure was employed as a first step towards determining whether the 50/10 screen might have failed to identify problems in exclusively served areas (i.e., areas served by both merging railroads but no others). This procedure was not employed in past Department rail merger investigations, but was employed in these two analyses because of our special concern to maintain competitive rail service in areas in which we could say with some degree of confidence that no third railroad was either an actual or potential competitor.

Dr. Pittman first identified BEAs in which only Santa Fe/SP operated stations. He then aggregated, on a commodity-by-commodity basis, all of the tonages moving into and out of these BEAs, and analyzed the largest of these movements for their susceptibility to truck competition. In addition to the movements identified through his 50/10 screen his verified statement reported movements involving originations or terminations from or to four BEAs as movements that the Santa Fe/SP merger could possibly affect adversely.

In the NS/Conrail investigation, the staff also began by identifying counties served exclusively by the two merging carriers. After identifying this universe of possible problem markets, the Conrail staff subjected these movements to the same screening procedures that it had utilized in analyzing markets identified through its 50/10 criteria.

The NS/Conrail staff paid particular attention to two factors. First, for each commodity in question, the staff looked at whether competition from trucking compa-

nies and barge lines was significant enough to thwart a possible post-merger exercise of market power by a single NS/Conrail entity. Where such competition appeared to be significant, the market in question was removed from further considerations—as it was in Dr. Pittman's analysis. Second, the staff looked for markets where NS and Conrail could actually compete for traffic. This was done because the staff believed that there may be situations in which both railroads operate in a county but are not competitors for certain movements. Such circumstances might arise, for example, where the merging railroads could serve shippers in the county that do not buy or sell the same commodities. Alternatively, one railroad may have the ability to exclude others, via prohibitive reciprocal switching rates, from serving plants that produce certain products. Finally, the railroads' lines may be located so far apart that shippers located near one would find it very costly to switch traffic onto the other. The NS/Conrail staff therefore relied, as the Department has done in past rail merger investigations, on evidence that both carriers actually had participated in movements (in this case, during 1983) to demonstrate that the merging railroads in fact represent alternative means of moving particular commodities into or out of the counties in question. The movements so identified constitute the list of problem markets in exclusively-served counties that was included with the Department's March 26, 1985 letter to Secretary Dole.

3. EXPORT SCREEN

Dr. Pittman's Santa Fe/SP analysis excluded from his destination "problem" list those commodities that were exported in large quantities from a port if the commodity was a bulk product that is traded at an arguably competitive price on world markets. This method was chosen because if the price of a commodity is determined by competition from foreign producers of the commodity, a railroad ordinarily cannot successfully charge monopoly rates for transporting the commodity to a particular port for export. (An origin problem could still be present, however, if the railroad could extract monopoly rents from the sellers of such goods, based on market power at the origin.) In the NS/Conrail merger, shipments of export commodities were not systematically excluded on this ground, but commodities such as coal and grain were excluded based on the facts of specific cases. In this respect, therefore, the approach the Department took in its NS/Conrail analysis may have been more likely toidentify movements of commodities as competitive problems than the approach Dr. Pittman took in analyzing the Santa Fe/SP merger.

4. ORIGIN/DESTINATION PAIRS AS A FOCUS OF ANALYSIS

In studying the Santa Fe/SP merger, Dr. Pittman looked not only at separate origins and destinations as potential areas for competitive analysis, but also at origin/destination pairs ("O-D pairs"). The Department's initial NS/Conrail analysis did not focus separately on O-D pair traffic movements. Subsequently, however, we did perform an O-D pair analysis in order to determine whether the results from such an analysis would have differed from the results generated by the approach that we actually applied. Using the same 1983 ICC Waybill data on which our origin and destination market analysis was based, and again focusing on 4-digit SPLCs, we identified 79 separate O-D pairs where NS and Conrail participation exceeded our standard 50/10 threshold criteria. Only 13 of these pairs represented commodity movements as to which neither the origin SPLC nor the destination SPLC appeared in our initial 50/10 screen of potential origin and destination problems.[1] Total revenues for NS and Conrail movements of the identified commodities along these 13 routes totalled less than $9 million, as shown by the enclosed computer printout (Appendix 3).

In sharp contrast, the origin and destination market analysis that we used in our initial NS/Conrail analysis identified—based solely on a 50/10 screen (i.e., prior to any further analysis of competition in these markets)—nearly 700 separate markets in hundreds of counties with potential post-merger competitive problems. These markets involved total annual revenues on NS or Conrail movements of more than $1 billion. Our origin and destination methodology identified many more problem markets because NS and Conrail were considered to be competitors when they both

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[1] These O-D pairs were not identified through our origin and destination screens because, for the commodities identified, there was significant competition from other railroads at both the origin and the destination. For example, in the movement of prepared bituminous coal from Floyd County, Kentucky to Lake County, Ohio, more than fifty percent of the coal moved by rail out of Floyd County moves via a railroad or railroads other than Conrail and NS, and the same is true for more than fifty percent of the coal received in Lake County.

carried a given commodity to or from a particular destination or origin, irrespective of whether the two railroads both carried the commodity between the same two points. (For example, if both NS and Conrail carried steel to Chicago, they were considered to be competitors even if the steel carried by one originated from a different county than the steel carried by the other.) By explicitly incorporating such source competition into our analysis, a much greater number of potential problem markets were identified than by looking only at O–D pairs.

Moreover, as to the 13 O–D pairs discussed above, we have not performed the additional market analysis necessary to determine whether they indeed could be considered "problem" markets, and it may weil be that several of them are not. In addition, a number of the identified O–D pairs (such as Wayne County, Michigan-Lorain County, Ohio, and Los Angeles County, California-Wayne County, Michigan) will continue to have competitive service after the merger as a result of the required divestiture. In short, although the Department's initial analysis of the NS/Conrail merger did not consider competition within particular O–D pairs, our subsequent O–D pair analysis indicates that there were no material differences in the results that we obtained using both methods.

5. SMALL REVENUE SCREEN

In evaluating the competitive implications of the NS/Conrail merger, the Department's decision to eliminate "small" markets was largely a practical one. It would have been impractical to analyze fully every market that might be affected in some small way by the merger. In the NS/Conrail analysis, therefore, the Department defined (and excluded from further consideration) a "small" problem county as one in which NS and Conrail were involved in movements of one or more "problem" commodities and total rail revenues for all problem commodities for the entire year of 1983 were less than $2 million, i.e., less than one trainload per week for the movement of most commodities. We did not include as "problem" commodity movements those STCC/SPLC pairs of under $250,000 in counties in which total revenues exceeded $5 million, and those STCC/SPLC pairs of under $1 million in counties in which total revenues were between $2 million and $5 million.

An enclosed computer printout (Appendix 4) provides a complete list of the STCC/SPLCs eliminated by this screen, the total revenues involved in NS/Conrail movements in these markets, and the percentage of each commodity that was transported by rail in 1977, on a nationwide basis. In reviewing this printout, it is important to bear in mind two points. First, none of these markets was subjected to the same detailed scrutiny given to the larger markets, and a full application of our NS/Conrail methodology to these small markets very likely would have eliminated many of them as potential competitive problems for reasons other than the small revenues involved. Second, we have not attempted to determine how many of these smaller markets will benefit from the divestitures required in our January 29, 1985, letter to Secretary Dole, although undoubtedly many of these counties will benefit from the proposed divestitutre. For these reasons, Appendix 4 subsantially overstates both the number and total size of the small market problems.

While Dr. Pittman's analysis of the Santa Fe/SP merger did not exclude all markets that might be affected in some small way by the merger, it is important to recognize that he too subjected only the larger markets to closer examination. This reflects the fact that Dr. Pittman was a witness providing facts to the ultimate decision-maker (the ICC), rather than a decision-maker trying to determine the significance of the competitive problem and whether and how the significant problems might be remedied. Accordingly, while the utilization of Dr. Pittman's approach in the NS/Conrail merger analysis would have produced a difference in the amount of "problem revenues" identified, it would not have changed the results of that anlysis or our ultimate recommendations.

6. AUTOMOBILE AND TRUCK DESTINATIONS

In analyzing the NS/Conrail merger, the Department excluded automobile and truck destination markets from its list of potential destination problems. We did so to allow for competition from the large number of foreign-built automobiles and trucks brought into these destination markets by ship—especially in counties near or adjacent to Pacific Coast ports. In contrast, Dr. Pittman did not specifically focus on automobile and truck destinations as important distinct markets and therefore did not consider the effects of imported autos and trucks on the markets involved in the Santa Fe/SP merger.

The Department's decision to exclude automobile and truck destination markets as areas of concern in our NS/Conrail analysis, however, did not cause that analysis

to understate significantly the competitive problems posed by the NS/Conrail merger. Indeed, many of the automobiles and trucks moving to these excluded destination markets have already been identified as movements in the problem origin markets—*i.e.*, Wayne County, Michigan (Detroit)—that were listed in our January 29, 1985, letter to Secretary Dole. Moreover, to the extent that automobile and truck destinations were included in our list of problem markets related to the NS/Conrail merger, most of those problems are addressed by our requirement that the railroads operating the divested lines have independent gateways at Buffalo, Toledo, Chicago, and St. Louis.

An enclosed computer printout (Appendix 5) lists each of the motor vehicle destination markets eliminated during our NS/Conrail analysis, and lists the total revenue on NS and Conrail movements of these commodities into those counties. More than one-half of this total dollar figure is for Los Angeles County alone. Appendix 5 printout also shows the 1977 national railroad transportation share for the commodity in question.

7. GRAIN MARKETS

The Department's analysis of the Santa Fe/SP merger disclosed that significant competitive problems would occur in grain transportation markets; in contrast, our analysis of the NS/Conrail merger did not identify significant grain transportation problems. However, the methodologies used in both cases were essentially the same, and the differences in results occurred primarily because of differences in the geographic features of the different areas of the country affected by the NS/Conrail and Santa Fe/SP merger. For example, grain moved in the West tends to travel longer distances than in the Midwest, and the water transportation alternatives that are a major competitive factor for Midwestern grain are not as readily available in the area affected by the Santa Fe/SP merger. The Department has recently described its analysis of the Midwestern grain transportation markets in a letter to Senator Lugar, a copy of which is enclosed.

8. THE REEBIE ASSOCIATES STUDY

Your August 2 letter makes reference to a study that you had requested be made, which we understand was performed by Reebie Associates. I will briefly discuss Reebie Associates' recent analysis of the NS/Conrail transaction, and compare it to the studies performed by Dr. Pittman and the Department's NS/Conrail staff. Using what is stated to be the same methodology adopted by Dr. Pittman, Reebie claims to have identified numerous "problems" that the Department did not identify using its NS/Conrail methodology, but which it allegedly would have identified had it used the Pittman methodology. While this letter is not the place to undertake a complete critique of the Reebie analysis, it is important to note that Reebie's attempt to produce the Pittman methodology is so fundamentally flawed in at least two respects as to place the entire study in question.

First, in analyzing the Conrail transaction, Reebie did not use the kind of information that Dr. Pittman used to screen out rail movements that are likely to be truck-competitive. While Reebie relied exclusively on Transearch data to establish market shares of competing modes, Dr. Pittman found that data to be incomplete for purposes of his analysis. This shortcoming is conceded by Reebie's Mr. Andrew Robertson in footnote 2 of his testimony submitted to the Senate Commerce Committee on June 12, 1985. Consequently, Dr. Pittman supplemented his analysis of intermodal competition with information from the record, shipper interviews and from economic literature. In particular, he found that the distance of a rail haul is a principal determinant whether motor carriers can compete for that traffic. This is of crucial importance in the NS/Conrail merger because the area of competitive concern in NS/Conrail is much more compact than the area in Santa Fe/SP. A comparison of Dr. Pittman's top 25 markets in Santa Fe/SP with Reebie's top 25 markets in NS/Conrail shows that most of the identified Santa Fe/SP movements are more than 1000 miles long, while most of the NS/Conrail movements are less than 500 miles long—a distance over which motor carriers are very competitive for many commodities. Applying this 500-mile rule of thumb to the Reebie tables yields a strikingly different result from that stated by Reebie: it reduces the "problem" tonnage by more than ninety percent—from 17.6 million tons to 1.7 million tons.

Second, in undertaking it analysis of exclusively-served markets, Reebie included those BEAs in which either Norfolk Southern or Conrail or both carried 100% of the traffic in a given year, even if other carriers also served the BEA. This sharply contrasts with the methodology used by both Dr. Pittman and the Conrail staff. In the latter two analyses, potential rail competition that did not satisfy the 50/10 cri-

teria was considered only with respect to those BEAs or counties in which the merging carriers were both offering service and in which they were the only two rail carriers offering service. The difference between the Reebie and Pittman analyses is especially significant on this issue, since a review of the first two pages of Reebie's Table VIII discloses that none of the BEAs identified by Reebie as "problems" is served exlusively by both NS and Conrail, and that several (e.g., movements from one point in Philadelphia to another or from Huntsville to Atlanta), are served by either Conrail or NS, but not both. These obviously are not O–D pairs where the merging carriers could compete with one another under any plausible scenario. Thus, a very large portion of Reebie's "problem" markets would not have been included in Dr. Pittman's totals, nor should they have been included in the NS/Conrail figures.

These two points, while not exhaustive of the discrepancies between the Pittman and Reebie methodologies, clearly show that the Reebie study does not replicate the methodology used by Dr. Pittman in his analysis of the Santa Fe/SP merger. More important, Reebie's methodology dramatically overstates the number and severity of the competitive problems that Dr. Pittman's methodology would have identified had it been properly to the NS/Conrail merger.

In conclusion, while there are some minor differences between the Department's Santa Fe/SP and NS/Conrail analyses, those differences would not and should not have affected our conclusions concerning the two matters. They reflect nothing more significant than two experts' slightly differing perspectives on how an inherently difficult competitive merger analysis should be accomplished.

I trust that this information is responsive to your request and will help alleviate your concerns about this important matter.

Sincerely,

CHARLES F. RULE,
Acting Assistant Attorney General, Antitrust Division.

Enclosures.[1]

Senator PRESSLER. In the meantime, I have a study done by Reebie Associates, a well-known transportation consulting firm. It was delivered to me yesterday. I find the results to be quite startling. I have here three computer printouts which supposedly identify points between which there are anticompetitive impacts as a result of the Conrail-Norfolk Southern merger.

This one I have in my hand was done by the Department of Justice. I am not certain what analysis was used, but it does not seem to present much of a problem since it is only five pages long. Let me emphasize that this is the Justice Department analysis of the Conrail situation.

Now, next is document No. 2. This document is what the Department of Justice came up with in the Santa Fe-Southern Pacific case using the so-called Pittman analysis. As you can see, it is quite a bit thicker.

Now, finally, applying the Pittman analysis—I cannot hold this one. Applying the Pittman analysis to the Conrail-Norfolk Southern proposal, this is what the document looks like, hundreds and hundreds of pages listing anticompetitive problems.

Now, the point I am making is that the Justice Department is using two different standards, one in the Santa Fe case where they have got their expert down at the ICC and quite another one in this Conrail problem, and that is baking numbers, to put it mildly, and that affects every railroad in the country except that one. And I invite anybody to dispute this.

In fact, we have here I think, in addition to the witnesses called, we have someone in the audience, an expert on these models that

[1] The enclosures have been retained in the Committee files.

are used. Could somebody put up their hand? There is an expert back there, and later I am going to ask him to be called forward.

But the point of the matter is that we are baking numbers, and if you do not believe it look at these three documents and tell me why it is not true. Now, these problems seem to be much greater than the proposed divestiture can cure.

Of the six major coal flows affected by this merger, Reebie shows that Justice only dealt with one in its divestiture program. That is, in cooking the numbers the Department of Transportation, of six major coal flows, they only used one. And I think that this committee should be dealt with in a straightforward manner.

Of the eight major corn flows affected, none are served by the Justice Department analysis. Of the 15 largest commodity flows, eight are not served by the divested line. In terms of origin cities, major problems in Detroit and Columbus are not addressed. Of destination cities, the Justice proposal misses major cities such as Evansville, IN, Washington, DC, and Cincinnati, and the list could go on and on.

I should also add that the Reebie analysis indicates that the problems of a Conrail-Norfolk Southern combination are considerably greater than those identified by Pittman in the Santa Fe-Southern Pacific merger. Not only do we now have doubts that the proposed new carriers can compete, but it seems clear the proposed divestiture does not begin to address even significant parts of the problem.

Now, I am no expert in this area and we have to look at this much closer than I have been able to since yesterday. There seems to be a very important question. My basic question is why, why the different analyses in these two major cases? I am not here to criticize anyone, but I think we need some answers.

We also need some answers from Morgan Stanley on its alternative to Norfolk Southern. I am particularly curious to know the final makeup of the group of investors and what percentage each has. I want to be sure that CSX is insulated from control.

Questions have been raised about whether Conrail money can be used by the Morgan Stanley group to buy the labor shares and how this arrangement compares with Norfolk Southern. As I said in the beginning, I am troubled by the Norfolk Southern bid. There are many questions to be asked and I would hope we do not rush this issue through without knowing its true impact.

The CHAIRMAN. You do not want us to rush, is that it?

Senator PRESSLER. Well, very seriously, with data such as this that is being rushed by the committee and apparently accepted by everybody. And let me say that, while all this has been considered for a long time, it has only been considered by this committee a very short time, and I do not apologize for asking some questions and I think it takes some time to answer them.

It is a very important issue, not only to my State but to many States. And if we get the answers to the questions, I am ready to go.

Senator EXON. Mr. Chairman.

The CHAIRMAN. Senator Exon.

OPENING STATEMENT BY SENATOR EXON

Senator EXON. Mr. Chairman, I find myself somewhat in the position of my friend and colleague from Washington, Senator Gorton. I am not locked into any position whatever on this. I do not agree with the chairman, though, that this is moving at a snail's pace.

I think this is a tremendously important move that we are making and, while I join my colleagues in saluting the proposition that we should return this railroad to the private sector as quickly as possible, I never have been able to see the full-court press that was initiated by the Department of Transportation some time ago. When the Secretary came over here, she did an excellent job and she almost swept this committee off its feet. We were jumping up and saying, is that not the greatest thing that has ever been done.

I really believe that we are moving along as fast as we should. You know, there is no real rush. The railroad is going to be there. It is operating at the present time at a profit.

I think it is in the interest of the consumers of this Nation, and an issue of importance to my State, to make sure that we are not only doing the right thing when we finish the process of returning this to the private sector but that we are returning it to the private sector with the best deal we can get for the American taxpayers, who are the ones that foot the bill when Conrail does not work out and has substantial losses.

So I am not locked into a position. I want to be fair to all. That is why I am delighted that at least today we have a full hearing on an interesting proposal that I think deserves at least the consideration of the members of the committee, those who have made up their minds and those who have not.

I thank the chairman.

Senator HOLLINGS. Mr. Chairman, let the record also show that, like Senator Gorton, I am a member of that budget conference, and if I leave momentarily it will be for votes up there on that conference committee.

This is most important to all of us and, as the distinguished chairman has emphasized, we have not rushed. We continue to plod along, and we want to hear fully from these witnesses, and I am delighted to do so now.

The CHAIRMAN. Thank you.

The first witness is John Riley, the Administrator of the Federal Railroad Administration. With him is Mr. Kenneth Brody, partner, Goldman Sachs.

STATEMENT OF HON. JOHN H. RILEY, ADMINISTRATOR, FEDERAL RAILROAD ADMINISTRATION, ACCOMPANIED BY CHRIS ROONEY, DEPUTY ADMINISTRATOR; AND KENNETH BRODY, PARTNER, GOLDMAN SACHS & CO.

Mr. RILEY. I would also like to introduce, joining me on my left, Mr. Chris Rooney, who is the Deputy Administrator of the FRA.

Mr. Chairman, my colleague Mr. Brody will address the specifics of the Morgan Stanley proposal in his testimony. For my part, I would like to view it from a broader transportation policy perspective. If some of my points seem familiar, the reason is that the

policy implications of this offer and in fact some of its most prominent participants are no different from the implications of the old Citicorp offer and the original management-Morgan Stanley public offering.

Secretary Dole weighed those offers, as well as the concept of a direct public offering, against three fundamental criteria:

First, the financial strength of the company after the sale;

Second, the impact of the offer on Conrail's ability to serve its shippers and communities;

And finally, the financial return to the Government.

Under these public interest criterion, the original Citicorp and Morgan Stanley offers failed the test of comparison with the Norfolk Southern plan, and under the same criteria, Mr. Chairman, the latest draft of the Morgan Stanley offer fails for many of the same reasons.

The first criteria is the most critical test, because financial strength is the key to service and job stability, and the Norfolk Southern proposal leaves Conrail in a stronger financial position than the Morgan Stanley plan for a number of reasons.

First, Norfolk Southern does not leverage even one dollar of the purchase price off Conrail's assets and uses none of Conrail's cash. In contrast, Morgan Stanley reserves the right and does in fact project the use of $300 million to $375 million from Conrail's cash to complete the purchase transaction.

Now, there should be no confusion about the impact of this difference. On the day of closing, the Norfolk Southern offer leaves Conrail with $800 million in cash and no additional debt. Above and beyond the $500 million operating reserve, that is $300 million added guarantee of capital investment, job and service stability.

In contrast, on the day of closing Morgan Stanley leaves Conrail with $500 million in cash, the absolute minimum the corporation needs to have to retain a safe operating reserve. And Mr. Chairman, it has not been Secretary Dole's objective from the beginning to seek minimum levels of job and service protection.

To say the same thing from a reverse perspective, Norfolk Southern pays a minimum of $1.575 billion for the corporation, including settlement with Conrail employees, while Morgan Stanley's investors pay $1.2 billion and leverage the rest out of the company.

The second point I would like to make is that Norfolk Southern has agreed to covenants strictly limiting dividends to a fixed percentage of annual income. Morgan Stanley claims to adhere to the same covenants, but if you read the fine print you will discover that the first year is defined as 18-month period.

Mr. Chairman, that is truly creative financing, and it enables the Morgan Stanley investors to withdraw approximately 50 percent more in dividends during the first year than Norfolk Southern can withdraw under the terms of the Memorandum of Intent. And not surprisingly, Morgan Stanley has also crafted significant exceptions to the minimum cash requirements.

But you know, the issue is broader than things taken away. It includes things brought, too, and the Norfolk Southern will bring Conrail at least $180 million in additional traffic volume every year. More volume means more jobs and more financial stability

for Conrail. The Morgan Stanley offer, in contrast, brings Conrail no additional volume.

The Norfolk Southern offer does not require Conrail to siphon off its cash into dividends to build a public market for Conrail stock. Unlike the Morgan Stanley investors, Norfolk Southern can earn a return on its investment from the improved traffic flows and better routings it acquires in the merger.

In other words, it does not have the same need as the Morgan Stanley investors have to draw a cash return, an immediate cash return from Conrail's reserves year in and year out. Now, in contrast, the Morgan Stanley investors apparently intend to make their money through dividends and through profits made on the quick resale of the Conrail stock.

Assuring these profits requires the investors to siphon off Conrail's cash reserves into consistently high dividends to build up the stock's value and marketability to insure its resale. A recent analysis by Kidder, Peabody & Co., which incidentally is one of the few investment bankers I think in this country that is not under retainer to any of the parties to the sale, projected that because of Conrail's weak marginal cash flows, dividend requirements similar to the Morgan Stanley plan would leave Conrail with a cash shortfall in the hundreds of millions of dollars by 1988. And Mr. Chairman, we have reviewed the new Conrail numbers which were released last week and reached the same conclusion.

Mr. Chairman, the Norfolk Southern/Conrail combination also broadens Conrail's traffic base, making it less recession sensitive by increasing Conrail's access to commodities such as coal and grain. Morgan Stanley does nothing to broaden Conrail's traditionally recession sensitive traffic base or lessen the impact of economic fluctuations on the carrier and the communities it serves. The impact of this consideration was driven home dramatically in the first 90 days of this year when a few bad weeks of weather and minor traffic fluctuations drove Conrail more than $40 million under budget.

Moreover, the efficiencies of the Norfolk Southern/Conrail merger will enhance Conrail's profitability by lowering its operating costs. The Morgan Stanley purchase does nothing to lower Conrail's costs or improve the efficiency of its operations.

Finally, Norfolk Southern brings Conrail borrowing power, along with the tremendous financial resources of the Norfolk Southern system. This provides the best possible guarantee of long-term job stability, service preservation, and high capital investment levels. In contrast, none of the miscellaneous shareholders in the Morgan Stanley plan have any reason to put their own cash resources into Conrail. They have no long-term stake in the corporation and have limited dollar investments at risk.

It is far easier to write off a decline in stock value as a capital loss. Does anyone seriously believe that the Metropolitan Museum of Art or Columbia University or Morgan Stanley's European investors will put additional cash resources into Conrail in time of need?

It is simply undeniable that a Conrail/Norfolk Southern combination is substantially stronger than Conrail standing alone. Moreover, the Norfolk Southern/Conrail combination offers shippers and consumers lower, more efficient single line rates on virtually

every commodity moving between the Northern and Southern States. In contrast, Morgan Stanley would leave shippers with the need to pay joint rates and switching fees, along with a loss of time competitiveness that comes in yard operations.

The divestitures associated with the NS offer will also break Conrail's monopoly on single line traffic movements between the Northeast and Midwest. Today there is only one railroad, Conrail, that can offer single line service from the Northeast to the major Midwest gateways at Chicago and St. Louis.

After the Norfolk Southern Corp.'s acquisition, Guilford Transportation Industries will offer competing single line service to Chicago and St. Louis from a broad range of eastern and northeastern markets, and this benefits not only northeastern shippers but shippers in my area of the country in the Upper Midwest and the Plain States who will now enjoy improved eastbound options from both the Chicago and the St. Louis gateways. A decision to sell to Morgan Stanley would forfeit these advantages and preserve Conrail's monopoly in the northeast.

The divestitures will also enhance the competitive viability of the regional carriers in the Conrail region. Conrail's only real competition in the northeast comes from these regional carriers, and their effectiveness as competitors has been progressively diminished by short hauls and closed gateways.

The divestitures provide these carriers with new connections and extensive reciprocal switching rights in the major markets of the Northeast. These actions increase the competitive capacity of the regional carriers, and they will preserve approximately a thousand jobs on the Pittsburgh and Lake Erie Railroad alone.

Most important, it is simply undeniable that financial strength is inseparable from service capacity. By leaving Conrail in a stronger position than Morgan Stanley, the Norfolk Southern offer better protects Conrail's service capacity.

Now, Mr. Chairman, in overview to the final criterion, financial return to government, I cannot help but recall the many times of the past 4 months that CSX, Conrail management or Morgan Stanley have accused Secretary Dole of giving the company away. And it's ironic that when they had to put their own offer down in writing, they offered to give it away for exactly the same price.

In an effort to establish some price superiority, Morgan Stanley now argues that its plan has a $600 million tax advantage over the Norfolk Southern offer. Mr. Chairman, that argument is 100 percent red herring, and I welcome the opportunity to address it and debunk.

Of the three Morgan Stanley tax arguments, the reddest herring and the easiest one to answer is the contention that job losses associated with the NS offer will cost the Government $245 million of lost railroad retirement taxes. That figure is based entirely on the assumption that there will be 10,000 jobs lost under an NS acquisition that would not be lost in a publicly held Conrail.

Morgan Stanley offers no support for that assumption, but for the members of this committee and for those of us at DOT, these should be familiar numbers because they are precisely the same numbers CSX predicted in its original testimony before this committee. Terming this alleged tax saving an "illusory promise," the

Pittsburgh Post Gazette, in its Tuesday, May 21, 1985 editorial, remarked that—and I am quoting:

> The figure is derived from Morgan Stanley's highly biased comparison of the impact of its takeover with that of Norfolk Southern on railroad retirement and unemployment tax payments. Indeed, this element of the proposal is so completely self-serving that it is difficult not to see the spoiling hand of Norfolk Southern's leading competitor, the CSX railroad system that is a primary investor in the Morgan Stanley plan.

Now, Secretary Dole answered these employment allegations in her last testimony before this committee, and I will not take more of the committee's time to repeat her response. But given the way Morgan Stanley is trying to use these numbers, it is important to understand why there would be no reduction in tax revenue even if the CSX threat was well-founded.

Now, CSX argues that an NS/Conrail combination would divert so much traffic from their railroad that 10,000 employees would have to be laid off. If a diversion of that magnitude did in fact occur, there might be a loss of employment to CSX, but given the fact that the number of employees required to serve 100 million tons of freight is a relatively constant number, there would be a countervailing gain in employment to NS/Conrail.

In other words, if it does in fact take 10,000 employees to service the diverted traffic of CSX, and that traffic is shifted to NS, then NS is going to have to hire 10,000 more employees, probably the same people in the same locale, to service the traffic. There might be an employment shift, but there would be no net decrease in rail employment, and thus no net decrease in the retirement and unemployment taxes paid.

Now, Mr. Chairman, the real answer is that these numbers just are not correct. They fly in the face of logic and of management's own estimates. The number of jobs on a railroad are directly related to volume. It is undeniable that an NS/Conrail combination carries at least $180 million in additional volume, and that a stand alone Conrail will not carry. Moreover, the lower single line rates NS can offer, by everyone's admission, will divert traffic from the trucking competitors. There will be a net increase, not a net decrease in employment in the rail industry under the NS plan.

Now, Morgan Stanley makes the additional argument that the Federal Government would lose an additional $350 million because an NS/Conrail combination could use Conrail's investment tax credits and depreciation more quickly than Conrail standing alone.

Before pointing out the flaws in this argument from a technical tax perspective, I cannot resist observing that this argument on its face concedes that Conrail is more likely to be profitable and more financially secure as part of the NS system than it would be standing alone. And that's a strong argument in its own right. But on a strictly revenue basis, there are at least two problems with the Morgan Stanley analysis.

First, note that Norfolk Southern acquires no investment tax credits at all in the Conrail purchase. Under section 4 of the Memorandum of Intent, NS forfeits 100 percent of Conrail's ITC's on the day of closing. That includes not only the credits acquired with Federal dollars, but the credits acquired with Conrail's own dollars after the Federal subsidy ceased.

The ITC's Morgan Stanley refers to are generated by new investments made after the date of closing with Norfolk Southern money. They derive from the investment of NS dollars, and any other owner, in a private sale or public offering, will generate the same level of ITC's with the same investment. And NS could generate the same ITC stream by investing the same dollars in some other part of its system or any other investment.

But second and more important, Morgan Stanley fails to point out that a stand alone, publicly-held Conrail can and in fact has produced a similar time advantage through the use of leveraged leasing. Under current law, a company that cannot made immediate use of its tax benefits can pass those benefits on to a wealthier taxpayer through sale and leaseback transactions.

Conrail management has utilized this and similar techniques to the tune of nearly $1 billion over the last 5 years. In fact, the entirety of Conrail's 1981 profits came from leasing transactions. And if you read the fine print, the Morgan Stanley proposal assumes that a publicly-held Conrail will indulge in a minimum of $125 million a year in tax leasing.

Now, Mr. Chairman, these leasing transactions give stand alone Conrail a similar ability to force immediate recognition of tax benefits. Using figures supplied by Coopers & Lybrand, who are Conrail's own accountants, Goldman Sachs has estimated that the net present value difference between the NS offer and a stand alone Conrail, even using Morgan Stanley's conservative leasing numbers, totals $30.77 million. And that assumes, incidentally, that current law prevails on the date of closing.

There appears to be a significant chance that fundamental tax reform will in fact become law this year, and if the current Treasury tax proposal becomes law, Goldman Sachs estimates that the Treasury would collect an additional $8 million from an NS/Conrail combination that it would not collect from Conrail standing alone.

Now, these are the net present value differences between the two proposals under the three issues Morgan Stanley raises.

In conclusion, Mr. Chairman, let me point out that there is another issue, one that Morgan Stanley does not raise but that should be raised. It stems from an apparently innocuous provision concerning Conrail's earnings and profits account that Morgan Stanley has inserted in its proposal.

Conrail presently has nearly a $1 billion deficit in its E&P account. A negative E&P account would have the practical impact of sheltering hundreds of millions of dollars in dividends paid to Conrail to individual shareholders from Federal income taxation. Morgan Stanley offers to yield back that negative account, and in fact has asked Congress to legislate a $500 million surplus in the account.

But on close inspection this is not the generous sacrifice it might seem on its face. Morgan Stanley shareholders are not individuals. They are either tax-exempt institutions or corporate purchasers who cannot benefit from a negative E&P account to any substantial degree because they already qualify for the 85 percent corporate dividend exclusion. In other words, Morgan Stanley's inves-

tors, given their makeup, are surrendering nothing, since they draw little or no benefit from the existence of a negative account.

Conversely, however, they can draw an enormous tax shelter from eliminating the account and establishing a $500 million positive balance. Why? Because distributions paid under a negative E&P account are considered return on capital, and they lower the investors' basis in its stock. The lower the basis, the more Morgan Stanley's investors will have to pay in capital gains taxes when they resell their stock shortly after closing.

By eliminating the negative E&P balance and replacing it with a positive one, Morgan Stanley effectively shelters its nontax exempt investors from an enormous capital gains exposure by precluding any reduction in basis from the payment of the $120 to $200 million in tax-free payments.

Mr. Chairman, this simple procedure would enable Morgan Stanley's investors to shelter up to $500 million in cash distributions from both capital gains and normal income taxation. And this is a particularly significant factor in a plan where the investors envision turning over a very substantial portion of their investment as quickly as possible.

The bottom line to the tax analysis is fairly simple. With the exception of the E&P account issue, there is in truth very little difference among the tax consequences of the various Conrail purchase formats. The net return to government is virtually identical. There is nothing in this third criteria to outweigh the enormous financial strength and service advantages NS brings to the transaction.

I appreciate the committee's indulgence in allowing me to finish my statement this morning.

I want to yield now to my colleague, Mr. Ken Brody. In addition to being a well-known investment adviser, I must inform the committee that within the last week Mr. Brody achieved an additional accolade. He was named one of the 25 most eligible bachelors in New York City.

Senator FORD. What is he doing here?

Mr. RILEY. And the newspaper article, which I would be happy to submit for the record, said--and I say this for the benefit of the staff—Mr. Brody has "an amazing knack for meeting and alluring women." And on that note I will yield to my colleague from Goldman Sachs.

The CHAIRMAN. In which capacity would you like to appear here?

Mr. RILEY. Given the makeup of the committee, I am afraid I will have to say only one.

The CHAIRMAN. Thank you.

Mr. BRODY. I really do not know what to say after that. I think I am ready to go home. But let me try to give a brief summary of our viewpoints on the Morgan Stanley proposal as it compares with the Norfolk Southern proposal.

We are pleased to be here for the third time on the topic of Conrail. I am starting to feel at home before this committee. As you know, we have been acting as the financial adviser to the Department of Transportation with respect to Conrail for a little over 3 years now. We have just sent a letter to Secretary Dole with our views on the Morgan Stanley proposal and have included it as our testimony.

We discussed a public offering proposal earlier this year before the committee in January 1985. Conrail management and Morgan Stanley proposed a public offering which proposed to give the Government $1.4 billion. Since then, interest rates have dropped, market prices have increased, railroad stocks are up about 5 percent, and the stock market is much more receptive to public offerings. And now we have an offer for about $1.3 billion, which consists of the $1.2 billion plus the excess cash plus the value of the warrants.

On the surface there appear to be some major differences between the two public offering proposals, but they really are much less than they seem. For example, the first offer used preferred stock. Now it is all common stock. But each proposal planned to take away approximately $120 million a year in dividends out of Conrail, and that is a serious matter. Each proposal, the first public offering proposal and the second, each planned to take away $300 million in upfront cash out of Conrail. The first proposal was a standard underwriting.

Now, Morgan Stanley does have commitments, but they require public offering right away, and the purchasers can walk if conditions deteriorate significantly. Let us take a look at two major specific areas of comparison between Morgan Stanley and the Norfolk Southern proposals. One is the financial strength of Conrail, and two is the financial return to the Government.

On financial strength, obviously a fundamental issue is the long term viability of Conrail. I would parenthetically add the willingness of short term or unit investors to invest in Conrail says little about long-term viability.

Hays Watkins, the CEO of CSX, put the risk most forcefully in his June 13, 1984 letter to Secretary Dole when he stated unequivocably, "Conrail will fail."

In our view, the long term, persistent and continuing loss in traffic and heavy competition from trucks in the Conrail market area poses a greater than normal risk that Conrail will face a doubtful future. Management has done a commendable and outstanding job in managing and reducing costs and using the benefits conferred by Congress. But future cost improvements are limited, while the deterioration of Conrail's revenue base unfortunately does not have such limits.

Conrail's recent results show that for the fourth quarter of 1984 and the first quarter of 1985, tonnage was below both the prior year period and below budget. The first quarter operating earnings were below the prior year period and approximately 30 percent below budget.

The latest Conrail forecast shows a 5-percent decline in tonnage for the year 1985 as compared with the prior budget. These recent results and the recent forecast do little to alleviate the long-term concern about viability.

The Morgan Stanley proposal increases our concern about the viability of Conrail as an independent entity. The Morgan Stanley dividend level of $120 million a year creates a drain on Conrail's financial strength. This dividend level exceeds by $50 million a year the free cash generated—projected by Conrail in its latest projections to be generated in the years 1986 to 1988.

Morgan Stanley will not be able to both make its dividend payments contemplated and make the capital expenditures that Conrail forecasts it needs to make. We are concerned that under the Morgan Stanley proposal, capital expenditures will suffer and harm Conrail. Morgan Stanley calls in its proposal for approximately $470 million less of capital expenditures for the period 1986 to 1988 than Conrail's recently released projections indicates the management would plan.

On the other hand, the Norfolk Southern proposal adds strength to Conrail. Norfolk Southern is a financially strong and very well managed company. The combination of Norfolk Southern and Conrail would clearly produce substantially additional income to Conrail, and Norfolk Southern has a long-term commitment to the railroad business.

Let me now turn to the second point of comparison which are financial returns to the Government between the two proposals. The areas are three. One is the cash proposed; two, the value of the warrants under the Morgan Stanley proposal; and three are the tax differences.

The price proposed by both Morgan Stanley and Norfolk Southern are the same, $1.2 billion plus the excess cash. Our estimate of the excess cash if Conrail hits its projections accurately and the transaction were to close at the end of the year, would be approximately $75 million.

The warrants have limited value, or better put, the warrant value is small compared to the total transaction. It is our estimate that the warrant value is in the area of approximately $20 million.

The third point is obviously the one that generated all the controversy, and that is the tax differences. We have studied this matter thoroughly, and I would like to take a few minutes to describe our conclusions.

Whereas the cash is a hard number and the value of the warrants can be estimated within reason, the value of the tax revenue differences is much more difficult to estimate and therefore much less reliable. The tax numbers are difficult to estimate because they depend upon a large number of future events, none of which are very predictable, including Conrail income and capital expenditures, Norfolk Southern income, Conrail's actions as an independent entity with respect to leasing and other tax transference mechanisms, Norfolk Southern's ability and/or willingness to make sure of Conrail deductions, and to a very large degree any changes in the Tax Code. In addition, assumptions about the behavior of the economy as a whole need to be made.

We have relied upon our outside advisers, namely Coopers and Lybrand, Hughes, Hubbard and Reed, and Sullivan and Cromwell for the preparation of the tax revenue analysis. We have reviewed with Morgan Stanley the tax analysis presented by them and have concluded, along with our advisers, that such analysis is substantially and unreasonably biased in favor of their proposal.

For example, the Morgan Stanley proposal uses the lower management income projections prepared in June 1984 for tax purposes rather than the higher estimates that they used themselves in the proposal with the effect of substantially increasing the tax revenue differential.

Their analysis also ignored the tax revenue loss from tax benefits taken by third parties entering into leasing transactions with a stand alone Conrail. Our analysis includes a number of conservative assumptions which I will not go into but which we believe tend to overstate the numbers that I am going to mention in a minute.

We believe on a present value basis the tax return to the U.S. Government under the Morgan Stanley proposal is approximately $30 million greater than under the Norfolk Southern proposal, utilizing the Morgan Stanley proposal's projections for Conrail income. Although we have not had the opportunity to review thoroughly Conrail's new 5-year forecast released on June 7, we estimate that the differential would increase, using these projections, but would still be significantly below $100 million.

Under the President's tax reform proposal, our analysis indicates that the differential between the two proposals would be eliminated entirely. Our analysis has not taken into account payments that might arise from a later settlement, the magnitude and deductibility of which are presently uncertain. Our preliminary view is that any such payments are likely to increase the tax revenue differential in the range of $30 to $50 million.

The other aspect of tax impact which was reviewed was the Morgan Stanley proposal's estimate of a $245 million reduction from railroad retirement and unemployment tax revenues. Our conclusion is that this putative reduction is actually unsubstantiated and does not represent an absolute revenue loss of any amount to the U.S. Government.

Let me just turn to some conclusion statements with respect to the proposal. In our view, the Morgan Stanley proposal, as contrasted with the Norfolk Southern proposal, offers the potential of a somewhat higher financial return, while it substantially reduces the financial strength of Conrail and somewhat increases the risk of nonconsummation of a transaction.

As Secretary Dole has stated and as we have advised the Department of Transportation, there always has been a tradeoff between the financial return the U.S. Government could achieve in the sale of Conrail and the resulting financial strength of Conrail. The degree of risk regarding the viability of Conrail that the U.S. Government is willing to assume and the consequences of maintaining or discontinuing the status quo of Conrail as an independent entity are matters of public policy to be resolved by the U.S. Government.

The Department has considered a number of proposals regarding the retention of Conrail as an independent entity and the sale of Conrail's common stock in public offerings and has concluded that such proposals do not reach the primary goal of insuring Conrail's financial strength. However, if the U.S. Congress were to decide in favor of maintaining Conrail as an independent entity, it is our judgment that the Morgan Stanley proposal is not an attractive alternative.

The risk-return relationship is unduly weighted in favor of the purchasers at the expense of the financial strength of Conrail and the financial return to the U.S. Government. The financial risk borne by the purchasers is quite limited, as they have the benefit of high dividends in addition to the ability not to consummate the transaction if conditions deteriorate significantly.

Furthermore, the purchasers stand to reap virtually all the potential gain an appreciation, if any, of the Conrail common stock. Therefore, if Congress were to decide in favor of maintaining Conrail as an independent entity, it is our recommendation that the U.S. Government should seriously consider alternatives to the Morgan Stanley proposal.

Thank you, Mr. Chairman.

The CHAIRMAN. Gentlemen, thank you very much. I take it both of you feel that as a general principle a stand-alone Conrail is not as strong a railroad as one that is affiliated with Norfolk Southern?

Mr. RILEY. I think that is a fair statement, Mr. Chairman. I went over some of the reasons for that in my opening statement. To reduce it to a similar perspective, a stand-alone Conrail does not have the benefit of any of the additional volumes and strengths that come from the acquisition. Conversely, a stand-alone Conrail that is dependent upon $120 million in dividend payments pays out its inherent strength.

The CHAIRMAN. I want to get to the dividend question now. One of the concerns is the cash situation. The Morgan Stanley proposal would use Conrail cash to make a significant payment to labor both for past contract concessions and for payment for stock held by the ESOP. In the case of the Norfolk Southern proposal, no Conrail cash would be used to pay labor. That is, Conrail's cash situation would be significantly stronger by hundreds of millions of dollars under the Norfolk Southern proposal than it would with the Morgan Stanley proposal. Is that right?

Mr. RILEY. That is correct.

The CHAIRMAN. Do you know how many hundreds of millions of dollars? Have you added that up?

Mr. RILEY. Well, it is $375 million on the text of the Morgan Stanley proposal.

The CHAIRMAN. That is just for the labor payments.

Mr. RILEY. Now, let me emphasize that that is simply for the labor settlement payment. What they have attempted to do is to match the Norfolk Southern offer of 375.

The CHAIRMAN. But with Morgan Stanley proposal that comes out of Conrail cash while with Norfolk Southern that comes out of Norfolk Southern?

Mr. RILEY. That is correct. In the Norfolk Southern case it comes out of NS. In the Morgan Stanley case it comes out of the company, but there is a second layer of analysis. Morgan Stanley allows some of the ESOP holders to sell an undefined amount of stock back to the company to the extent that the company has the cash to buy it, and there are only two implications of that. They are both bad.

One is that the company's cash resources will continue to be used to leverage the ultimate purchase of all outstanding stock. The other is that there will simply be no market from which the ESOP holders could sell their stock.

The CHAIRMAN. All right. Now, also, the Morgan Stanley projections for dividend payments, that would be $120 million annually. Is that correct?

Mr. BRODY. The projection, their plan calls for $121 million per year in dividends.

The CHAIRMAN. And that is what kind of return on the investment? I think it is 8.4 percent. Is that right?

Mr. RILEY. Off the top of my head, that seems like the right calculus.

The CHAIRMAN. Would that be high or low or average compared to dividends paid by other railroads?

Mr. BRODY. That return, looked at that way, is high compared to what other railroads pay.

The CHAIRMAN. Much higher than average, isn't it?

Mr. BRODY. Substantially higher.

The CHAIRMAN. In fact, it would be the highest dividend return of any railroad in the country. Isn't that correct?

Mr. RILEY. That is correct by a rather wide margin.

The CHAIRMAN. Do you think that that kind of proposed dividend payment would leave the railroad in a strong position or a weak position?

Mr. RILEY. It would have to leave the railroad in a weak position. I would yield to Mr. Brody for his analysis. We have taken the new projections put together by Conrail and run those numbers out through 1988. They would reduce Conrail's cash from $846 million today to $277 million in 1989.

The CHAIRMAN. Now, what would they have to do to make up the cash? What would their alternatives be?

Mr. RILEY. Disinvest. Ken, let me yield to you to also answer that question.

There really only are three alternatives. You either do not pay the dividend, in which case you lower the value of the stock and weaken the company's equity position in financial markets, or you disinvest, which is apparently what the intent of this plan is, because they are over $460 million below management's investment projections.

The third is that you cut service and lay off employees, and the plan appears to assume the laying off of about 4,500 employees.

The CHAIRMAN. It appears to assume the laying off of about 4,500 employees?

Mr. RILEY. Now, in fairness, over a 5-year period, Mr. Chairman.

The CHAIRMAN. Is that more than the Norfolk Southern would anticipate laying off or less?

Mr. RILEY. Norfolk Southern estimates a 1,200 job impact.

The CHAIRMAN. Norfolk Southern says that 1,200 will be laid off, and the Morgan Stanley program would lay off 4,500?

Mr. RILEY. Yes; those are not completely comparable figures in the sense that one is a 5-year operating plan, another is a short-term impact, but let me say to the chairman that there is a finite relationship between employment and volume, and when one concedes that there is at least 180 million more in volume on the system, which I think all parties do, that has to lead to the conclusion that there will be more jobs on an NS Conrail than there will be on a Conrail standing alone.

The CHAIRMAN. Now, how about rates to shippers? Would it be likely that with the dividend requirements of the Morgan Stanley arrangement that rates would be increased over what they would with Norfolk Southern or not?

Mr. RILEY. Let me yield to my colleague, Mr. Rooney.

Mr. ROONEY. Mr. Chairman, it is my understanding that they did project a rate increase into the proforma statements that Morgan Stanley provided to the investors.

The CHAIRMAN. Would you explain what you mean by that?

Mr. ROONEY. What I guess I intend to say there, Mr. Chairman, is, they assumed that rates would increase 5 percent.

The CHAIRMAN. Morgan Stanley did?

Mr. ROONEY. Yes.

The CHAIRMAN. Is that reasonable? Is that what has been happening in the rail industry? Is that what would be anticipated if Norfolk Southern bought the railroad?

Mr. ROONEY. It is a difficult objective to achieve in a railroad perhaps 30 percent of whose revenues are piggyback traffic, directly competitive with trucks, Mr. Chairman.

The CHAIRMAN. It would be hard to increase rates by 5 percent and not lose traffic even if you wanted to. Is that right?

Mr. RILEY. Mr. Chairman, the average industry is about, I believe, and I will correct this figure if I am wrong, 1.7 percent this year; 5 percent is substantially above the actual industry average.

[The following information was subsequently received for the record:]

According to the Bureau of Labor Statistics' Index of Rail Freight Rates, the increase between April 1984 and April 1985 (the last 12 month period for which data are available) was 1.0 percent.

The CHAIRMAN. Would a 5-percent increase be good for the coal industry?

Mr. RILEY. I think you will have to ask someone from the coal industry that. It certainly does not strike me as being good.

The CHAIRMAN. How about farmers? Would it be good for farmers or bad for farmers?

Mr. RILEY. Well, I am a farmer, so I can say without reservation that there is no question that would not be good for farmers.

The CHAIRMAN. How about industry in the Northeast? Would it be good for industry in the Northeast or bad for industry in the Northeast?

Mr. RILEY. Of course it would be bad for industry in the Northeast. Mr. Chairman, it presents them with a dilemma. Either they raise the prices and lose the traffic or they fall below their own projections and disinvest to make up the difference, and both horns of the dilemma are bad because they have no strong parent to fall back to. That was Hays Watkins' point, and he was right.

The CHAIRMAN. The same concern that TWA is voicing about Carl Icahn and disinvesting? Is there a parallel?

Mr. RILEY. Fortunately for me, Mr. Chairman, I have no knowledge whatsoever of the TWA situation. I will yield to Mr. Scocozza on that.

The CHAIRMAN. Senator Hollings.

Senator HOLLINGS. Thank you, Mr. Chairman.

Mr. Brody, when you say that the purchasers are quite limited in risk, as they have the benefit of high dividends in addition to the ability not to consummate the transaction if conditions deteriorate, can you elaborate on that? In other words, when they buy the stock, it is not a scheduled kind of purchase once they have the

stock can see what is happening, and then can start offloading their ownership? Is that right, when you say not consummate?

Mr. BRODY. There are two points there. The point of not consummating is that it is just not closing the transaction with the United States to purchase Conrail if conditions were to deteriorate significantly.

Senator HOLLINGS. Wait a minute. That is what bothers me. You are saying that they can make this offer, but then they do not have to consummate the offer. What is the timeframe in there, and when would the commitment be firm? I have a firm offer right now from NS, and why is this not unfirm? Or why do they have an ability not to consummate? That is what I want you to elaborate on.

Mr. BRODY. In a practical sense, one must take a look at any transaction at any point before it closes, before it actually happens and has some estimation of whether or not it is likely to close.

Senator HOLLINGS. Right.

Mr. BRODY. There are a whole host of conditions that exist in any contract. There are some conditions in the Norfolk Southern contract. And all that we are saying there is that our analysis of the different conditions and the makeup of the investors and the long-term interest of Norfolk Southern and the short-term, more short-term interest of Morgan Stanley purchasers is that there is a somewhat likely—there is a somewhat greater chance that the Morgan Stanley deal if it were selected would not close with the U.S. Government as compared to the Norfolk Southern.

Senator HOLLINGS. Could that be the scheme? I do not know that I am qualified to ask the question properly, but I spent a good bit of time with Judge Sirica while he was writing his book and talking about Federal judges.

He said, Senator, never appoint a judge who has not been in the pits. He said, if he has been in the courtroom as I have, he could have smelled something was wrong with Watergate, as I did. It was not the rules of evidence. It was just a feel from hard experience.

Now, a feel from hard experience tells me after 35 years of trying cases and listening to cases being tried up here in the Congress that there is a conspiracy going on here, and I am against any conspiracy that I am not a part of and I am wondering, when you get a fellow of the repute of Hays Watkins coming in and saying that Conrail just cannot stand by itself, having made a rather questionable proposal that was not accepted by the Senate, and then coming in and totally turning around, all of a sudden getting these folks together, and then the expert here is telling me the public offering proposal may not even be consummated, could conspiracy be the intent?

We have this time and again—the other side is playing a game to stretch the process out and maybe have their proposal accepted, and then by the end of the year, when we have gone home for Christmas, have it, not consummated. And then we have to start all over again.

How soon could that be decided? Or could there be some requirements in here that once we make a decision, that is a consummation? That is what worries me.

Mr. BRODY. To be fair, Senator, to the Morgan Stanley proposal, which is what we have tried to do in our entire analysis, we would

not look at the risk of consummation similar to the way that you have described.

Senator HOLLINGS. You would not?

Mr. BRODY. No; what we would say is that evaluating the two proposals, that there is a better chance to put, just a somewhat better chance that the Norfolk Southern proposal would close as compared to the Morgan Stanley proposal. Now, as to what CSX's intentions are and whether or not they would hope to have it delayed is something I just cannot respond to.

But the first part of the question that you asked really relates to some of the reason why there is likely to be a pretty good chance of the Morgan Stanley proposal closing. They do have commitment letters from responsible institutions, corporations, and what they have is, they have the protection of a very high dividend level, as the chairman was noting.

That dividend level is so high relative to what other railroad stocks yield that those investors in the short run have the comfort of seeing that dividend level support the price of the stock, and as a condition of their purchasing Conrail, they have insisted upon being able to sell the stock immediately after they consummate the transaction with the Government.

Senator HOLLINGS. And they could sell it around to each other—let me ask a question on this and comment at the other end. If I am CSX, and I have failed to keep Conrail separate, then while momentarily I am listed for a 7-percent interest, how soon from an investment banker's standpoint could I gain control on that sale to each other?

I mean I do not know Harbert International, but I am just using the arithmetic of the schedule of investors, and I could run down and see four or five that I could buy out and have effective control. Could CSX do that?

If you really had the intent of trying to get control of Conrail yourself after the stock was purchased and the whole plan consummated, and since all of the particular investors immediately have an opportunity to sell, what is to prevent CSX from taking it over?

Mr. BRODY. The Morgan Stanley proposal, as I understand it, and I suspect they could talk better about their proposal than I can, does provide safeguards during the first 5 years such that any of the investor group would not be able to increase their position over 10 percent.

Now, as to what could happen if someone outside the investor group wanted to gather up stock is something I think they contemplate on dealing with but I am not quite sure.

Mr. RILEY. Mr. Chairman, if I could just add a comment on that, the very factors that my colleague, Mr. Brody cites that build security for the investors in closing, the high dividend payments, the cash turnaround, are the very same factors that build in security for the company over the long run, and that is the fundamental tradeoff that concerns us.

Moreover, on the second half of your question, 5 years or 4 years or 1 year from now, when the stock is being resold, the people who are reselling it to whoever, to Carl Icahn or whoever, or CSX and the other investors, and I think then has to question what their in-

terest and commitment in the company's long-term future would be.

Senator HOLLINGS. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Long.

Senator LONG. I have been told that five regional railroads, the Chicago North Western, Illinois-Gulf Central, Grand Trunk, Milwaukee Railroad, and Kansas City-Southern have estimated up to $183 million a year of traffic will be diverted from these railroads to the combined Norfolk Southern-Conrail system. Is that your information, or is your information contrary to that?

Mr. RILEY. Our information is different, Senator Long. Let me answer that two ways. Our estimates show a total aggregate diversion from all midwestern carriers, including CSX, of around $180 million. That is just over. We show that none of those Midwestern carriers would have a diversion in excess of 2 percent, which is not an employment related diversion.

The Kansas City Southern has already reached an agreement with the Norfolk Southern on gateway protection. Norfolk Southern has offered the same agreement to the other carriers. In fact, we were meeting and negotiating as recently as yesterday.

And what I would like to do for the purpose of time is, I would be happy to provide a lengthy written answer addressing each of those, what numbers we reached, how we reached them, and why our numbers differ. And I would be glad to do that.

Senator LONG. So has an agreement been reached with these other carriers?

Mr. RILEY. At this point, I thought I caught four of them. An agreement has been reached with the Kansas City Southern, and that agreement has been offered to the other carriers, but let me emphasize that even in the absence of an agreement, our primary diversion analysis which had the advantage of using the way-bill sample demonstrated no diversion over 2 percent.

I have to emphasize that in doing that, we really did not have a position at the point we did that. The Norfolk Southern was one of many people we were looking at as potential buyers, so it was before they were selected.

Senator LONG. Now, in your opinion how much additional traffic is likely to be placed in the situation where it can be regarded as captive traffic if the Norfolk Southern-Conrail merger and related divestitures are completed?

Mr. RILEY. Mr. Chairman, let me request that I can submit a written answer to that for the record. It is our view that the divestitures resolve that issue because they bring a new market entrant into areas where there would be a diminution in competition. This is the Justice Department's conclusion.

My reason for asking for a written statement is only that it is complex, and I would like to go over them point by point for you, but I would be happy to provide that.

[The following information was subsequently received for the record:]

There will actually be a reduction in captive traffic. DOT determined that in 1984 Conrail (CR) and Norfolk Southern (NS) exclusively served 54 locations, 14 of which were inactive (meaning no traffic originated or terminated at these locations according to the one percent waybill sample). Of the remaining 40 locations 21 are located

on lines to be divested to Pittsburgh and Lake Erie or Guilford Transportation Inc. At the remaining 19 locations 157,363 carloads would remain captive to a combined NS–CR system. However, of those 157,363 25,760 carloads are coal shipments from Wabash Mine, IL. to Carrol, hauled under contract and not subject to competition. Both Wabash Mine and Carrol are exclusively served by NS and CR.

NS–CR JOINT SOLE SERVED LOCATIONS

Location	Traffic (?)	Divested (?)
Black Rock, NY	No	Yes
Westfield, NY	Yes	Yes
North East, PA	Yes	Yes
Bridgeville, PA	Yes	Yes
Deepwater Bridge, WV	No	No
Alloy, WV	Yes	No
Saybrook, OH	No	Yes
Geneva, OH	No	Yes
Mentor, OH	Yes	Yes
Willoughby, OH	Yes	No
Wickliffe, OH	Yes	Yes
Solon, OH	Yes	Yes
Bedford, OH	Yes	Yes
Fairlane, OH	Yes	No
Wellington, OH	Yes	Yes
Oak Harbor, OH	No	No
Maple Grove, OH	No	No
Huron, OH	Yes	No
Orrville, OH	Yes	Yes
Smithville, OH	Yes	Yes
Bucyrus, OH	Yes	Yes
Findley, OH	Yes	No
Delphos, OH	Yes	Yes
Mingo Jct., OH	Yes	Yes
Stenbenville, OH	Yes	Yes
Brilliant, OH	Yes	Yes
Yorkville, OH	Yes	Yes
Tiltonville, OH	No	Yes
Scio, OH	Yes	Yes
Bowerston, OH	No	Yes
Coshocton, OH	Yes	Yes
Bannon, OH	Yes	No
Worthington, OH	Yes	No
Clare, OH	No	No
Avondale, OH	Yes	No
Butler, IN	Yes	No
Fort Wayne, IN	Yes	Yes
Millersburg, IN	No	No
New Paris, IN	No	No
Osborn, IN	Yes	No
Decatur, IN	Yes	Yes
Red Key, IN	Yes	No
Hartford City, IN	Yes	No
Wabash, IN	Yes	No
Bunker Hill, IN	Yes	No
Kokomo, IN	Yes	Yes
Clymers, IN	Yes	No
Alexandria, IN	Yes	No
Oakland City, IN	No	No
Carol, IN	Yes	No
Reddick, IL	No	No
Delong, IL	No	No
Full, IL	Yes	No
Wabash Mine, IL	Yes	No

NS–CR JOINT SOLE SERVED LOCATIONS—Continued

Location	Traffic (?)	Divested (?)

Total traffic all locations: 258,014 cars.
Total traffic at sole served locations after divestiture: 157,363.

The CHAIRMAN. Senator Rockefeller. Senator Exon. I am sorry.

Senator EXON. Senator Rockefeller was here before I was.

Senator ROCKEFELLER. Go ahead.

Senator EXON. John, thanks very much for coming. I always enjoy your testimony. You are so reserved.

I am wondering if you have seen the letter from the Congressional Budget Office to the chairman on what the net would be from the sale—the letter of June 6, from the Congressional Budget Office to Hon. John C. Danforth. Have you seen it?

Mr. RILEY. Well, I have not seen the letter. I have seen the final conclusions of the letter and some of the numbers they used and how they calculated them.

Senator EXON. Is it not true that those numbers differ somewhat from what you have been testifying here to this afternoon?

Mr. RILEY. In truth, Senator, that is a very good question, and my answer to you is that the tax numbers differ only in form and not in substance, and if you give me 1 minute, I would like to explain that statement.

Senator EXON. Please do.

Mr. RILEY. This is a difficult concept to do verbally, so I brought one chart with me today, and if I can put it up——

Senator EXON. You have been waiting for someone to ask that question.

Mr. RILEY. Let us say I have not been waiting for it, but I suspected that somebody might. If I could ask Mr. Rooney to lift the chart up. Bear in mind by way of overview that those numbers are not a comparison of Norfolk Southern to Morgan Stanley.

They are a comparison of Norfolk Southern to keeping Conrail and all the arguments raised vis-a-vis Norfolk Southern apply with equal force to Morgan Stanley, but let me make a point on this chart. You will see why I did it in a chart when I explain it, because it is very hard to verbalize it.

Inherent in the use of depreciation and ITCS and the application of a timing comparison is the fact that the company that uses them sooner will have an outflow in the early years and a recapture in the outyears because they have consumed their credits early and do not have them for the outyears. It takes about 10 years to run that cycle.

Now, as this graph illustrates, the line that you see here with square boxes represents the taxes the Norfolk Southern would pay without purchasing Conrail. The other line, the dotted line are the taxes it would pay if it did purchase Conrail, and what you see is that in the short run there is an outflow and then there is a recapture starting in 1990.

The way you calculate the net impact of the tax consideration on this sale is to subtract this from this and give it a net present value. That is what I did in my statement.

There is nothing wrong with the Joint Tax Committee's arithmetic. The trick is in the question. And it is proof of the old adage that if you can phrase the question, you can dictate the results. Joint tax was asked to calculate the net tax impact over only the first 5 years. If you do that you get this. Do you see what I am saying? You isolate the spend-out period. You do not consider the recapture period. It is a 10-year cycle. When you consider both, you get both the blue and the red.

Now, I did this chart because I couldn't find a way to verbalize that quite as well as the chart does, but our numbers, and Goldman Sachs has submitted as part of its testimony about a 150-page analysis to you and to your staff on this, suggests that under current law, when you add these two things together, there is about a $30 million difference, not counting the capital gains shelter.

We have not been able to do an estimate on the capital gains shelter because I did not have until this morning a breakdown of how much each investor had in the Morgan Stanley plan. Under the President's tax proposal or any reasonable variant thereof, the difference is even smaller, if not deminimus, when you do a similar comparison of NS/CR merged versus NS and CR standing alone.

All this chart illustrates is that if you draw the line in 1990 that is just as unfair as drawing the line at 1990 and saying give me the difference over the next 5 years.

Senator PRESSLER. Would my good friend from Nebraska yield?

Senator EXON. Certainly.

Senator PRESSLER. This is indeed an interesting and eloquent comparison of Treasury receipts from Conrail and Norfolk Southern stand-alone versus merged, but it does not compare it against the Morgan Stanley issue, and I would like to say that I have a copy I would like to make in the record that I have asked—on June 10 I sent a letter asking the Congressional Budget Office to compare that to the Morgan Stanley. Do you happen to have a chart comparing it to the Morgan Stanley proposal?

Mr. RILEY. I do not for one reason. I have given you one of the two numbers, Senator. There is about a $30.77 million difference under present law, not counting the capital gains shelter.

To calculate the value of the capital gains shelter, we had to know how much each of the investors had in the company because some are tax exempt, and we did not have that data until this morning, because Morgan Stanley would not give it to us until today.

Senator PRESSLER. But if my colleague would yield from Nebraska—he has the floor—I will be very brief.

Senator EXON. Go ahead.

Senator PRESSLER. Mr. Chairman, I have here a copy of a letter dated June 6, 1985, from the Congressional Budget Office addressed to you which spells out the budgetary impact of the Conrail/Norfolk Southern merger as compared to not selling Conrail at all. I would like to have that inserted in the record at this point, along with any relevant graphs or tables which I believe ar forthcoming.

The bottom line of the CBO letter as it relates to taxes is that they estimate Norfolk Southern will shelter approximately $400 million as a result of this deal.

I also have a letter dated June 10 from me to CBO asking that they run a similar analysis comparing the budgetary impact of the Morgan Stanley proposal to a Norfolk Southern acquisition. I would also ask that a copy of my letter and CBO's response, along with appropriate graphs or tables, be printed at this point.

[The letters follow:]

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
Washington, DC, June 6, 1985.

Hon. JOHN C. DANFORTH,
Chairman, Committee on Commerce, Science and Transportation, U.S. Senate, 508 Dirksen Senate Office Building, Washington, DC.

DEAR MR. CHAIRMAN: The Congressional Budget Office has reviewed S. 638, the Conrail Sale Amendments of 1985, as ordered reported by the Senate Committee on Commerce, Science and Transportion, April 30, 1985. The bill provides for the transfer of Conrail to the private sector and cancellation of the federal government's interest in Conrail debt and preferred stock, as detailed in the Memorandum of Intent between the United States and Norfolk Southern Corporation. This letter provides an estimate of the budget impacts of S. 638 through fiscal year 1990, as required by Section 403 of the Congressional Budget Act of 1974.

If this bill is enacted, we estimate that the federal government would be paid about $1.4 billion in 1986 for the sale of Conrail, would save about $10 million a year in labor protection payments, and would lose about $0.4 billion in tax revenues and $0.8 billion in future interest and dividend payments from Conrail over the 1986–1990 period. There are, however, a number of uncertainties surrounding this estimate and they are discussed in detail below. Also, this estimate does not adjust future year budget effects to account for the time value of money. Moreover, this estimate does not represent an economic analysis of the proposed sale, which would extend farther into the future and would encompass a number of other factors, including whether or not the government should be in the railroad business. CBO is currently preparing such an analysis, and we will be pleased to share it with you when it is completed later this year.

BUDGET IMPACT

CBO, in conjunction with the Joint Committee on Taxation (JCT), has estimated the budgetary impact of S.638 compared to the situation if no legislation is enacted. In the latter case, we have assumed that the United States continues to hold its interest in the common stock of Conrail, labor protection payments continue to be made by the federal government, Conrail does not pay state or federal taxes, and interest on debentures and dividends on preferred stock are paid to the federal government, according to the 1979 financing agreement between Conrail and the United States Railway Association (USRA).

Compared to this base case, the legislation would affect the budget in four ways:

(1) the government would receive payments from Norfolk Southern for the purchase of the Conrail common stock now held by the government;

(2) the government would save future labor protection costs, which would be borne by Norfolk Southern and other railroads acquiring divested propreties;

(3) the government would lose future interest on debentures and dividends on preferred stock, which it would be entitled to receive from Conrail under the 1979 financing agreement;

(4) the government would lose tax revenues because of Norfolk Southern's acquisition of Conrail.

We will discuss each of these effects separately in the remainder of this letter.

Purchase price

Under the terms of the Memorandum of Intent, the Norfolk Southern Corporation agrees to pay the federal government, on the closing date, a cash purchase price of $1.2 billion plus any cash and temporary investments held by Conrail that exceed $800 million. For the purposes of this estimate, CBO has assumed a closing date of January 1, 1986. At the end of December 1985, we estimate that Conrail will have cash on hand of approximately $1 billion and that the Norfolk Southern Corporation would make a one-time total cash payment to the federal government of about $1.4 billion in fiscal year 1986.

Labor protection payments

The bill would eliminate labor protection payments currently made by the federal government, except to those individuals who are eligible prior to the sale. Labor protection payments to employees laid off after the sale would be covered by the Norfolk Southern Corporation and other railroads acquiring divested properties. The outlay savings to the government from eliminating the federal labor protection payments would be approximately $2 million in 1986, and $10 million annually from 1987 through 1990.

Interest and dividend loss

The bill would also cancel Conrail's debt and preferred stock now held by the federal government. The federal government, through the USRA, currently owns $851 million of debentures, $2.3 billion of Conrail Series A, and $32 million of Series B preferred stock. Conrail is required to pay interest, dividends, and principal to the government under terms specified in the Amended and Restated Financing Agreement between USRA and Conrail of 1979. Generally, under this agreement, Conrail is required to make payments once it cumulative net income exceeds $500 million; the amount of the annual payments then is either the amount of cumulative net income (excluding payments) over $500 million or one-half of the previous year's net income, whichever is lower. We estimate that if the United States were to retain ownership of Conrail, payments to the federal government would begin in 1988. These payments would be slightly less than $0.3 billion in each year, totaling approximately $0.8 billion from 1988 through 1990. (Such payments would continue after 1990, assuming that Conrail would remain profitable, but the amounts paid might differ.) If S. 638 is enacted, the government would not receive these payments. Offsetting receipts would thus be $0.8 billion lower and net outlays correspondingly higher over the 1988-1990 period. (This same result would occur from any sale of Conrail that involves cancellation of Conrail's debt to the federal government.)

Tax revenues

The Joint Committee on Taxation estimates revenue losses to the federal government of approximately $0.1 billion annually from 1987 through 1990, as a result of a sale to Norfolk Southern. (The JCT has indicated that as more information becomes available, revisions may be necessary.) CBO has reviewed and concurs with these revenue estimates. These revenue losses would arise primarily because of Norfolk Southern's ability to use Conrail's depreciation deductions to offset taxable income generated by other portions of the merged corporation. A portion of the revenue losses would also result from the deductibility of Norfolk Southern's proposed payments to Conrail employees for outstanding wage claims. These losses are partially offset by a revenue increase resulting from Conrail's likely shift from leasing to purchasing equipment, if sold to Norfolk Southern. The details of the revenue estimate are discussed below.

KEY ASSUMPTIONS

The budgetary impact of the sale is based on several key assumptions:

(1) Net Income Projections—estimates of Conrail's net income critically affect both the estimate of payments of interest and dividends to the government and the estimate of tax losses;

(2) Revenue Estimating Issues—a series of legal and economic assumptions concerning the tax effects of the sale strongly influence the revenue estimate.

These assumptions are discussed in more detail below.

Net income

CBO's estimate of Conrail's net income in the absence of a sale is based on an analysis provided by USRA on April 1, 1985. That report essentially adjusted projections prepared by Conrail. CBO then made both technical and economic adjustments to the USRA estimates. Two technical adjustments to operating income were necessary. First, USRA assumed that Conrail would make all labor protection payments after 1984; we assume that, in the absence of a sale, the federal government would continue to make labor protection payments and Conrail would not bear such costs. Second, USRA assumed that Conrail would begin to pay state taxes in 1985; we assume that, in the absence of a sale, Conrail would continue to pay no state taxes. These adjustments increase Conrail's net operating income by $40 million annually.

In addition to these technical changes, CBO adjusted USRA's projections for operating income to make them consistent with the macroeconomic assumptions in the Senate-passed 1986 budget resolution. USRA's scenario forecasts a recession for 1986

and 1987, with a 42 percent decrease in net income between 1985 and 1986. The economic assumptions underlying the 1986 budget resolution do not include an explicit recession assumption. In order to adjust operating income to reflect this defference, CBO started with USRA's 1985 net operating income (including technical adjustments) and increased 1986 and 1987 income to reach the adjusted USRA 1988 level. After 1988, the last year in which USRA forecast net income, CBO assumed a 5 percent annual increase in net operating income, approximately the same as used for the previous years.

CBO also adjusted USRA's estimate of non-operating income. USRA assumed no interest income on Conrail's cash over $500 million. CBO estimated that interest income would be earned on all of Conrail's cash on hand, and would be earned at interest rates consistent with those used in the Senate-passed budget resolution. Under these assumptions, Conrail's projected net income would be about $500 million in 1986, rising gradually to about $600 million in 1990.

While estimated net income significantly affects both payments to the government and revenue losses, these effects are partially offsetting. For example, if USRA's recession assumptions were adopted, resulting in lower Conrail net income, the total payments forgone by the government if Conrail is sold would decrease from $0.8 billion to $0.7 billion over the 1986–1990 period. Tax losses from the sale, however, would increase from $0.4 billion to $0.5 billion over the same period.

Revenue estimating issues

Estimating the revenue effects of the legislation raises a number of issues that have not been completely resolved. The potential availability of Conrail's approximately 43 billion in future depreciation deductions to offset future Norfolk Southern taxable income is of greatest significance to the estimates. A second issue with large revenue implications is the treatment of Norfolk Southern's proposed $375 million financial settlement with Conrail labor. The third issue is the extent to which aggregate leasing in the economy will change as a result of the sale. Certain assumptions regarding these issues, decribed below, were required for estimating purposes. A more complete discussion of the revenue issues surrounding the proposed sale can be found in *Description of Revenue Provisions of H.R. 1930 and Background Relating to Proposed Transfer to Norfolk Souther Corporation*, a JCT print.

Conrail's depreciation deductions can be used to offset Norfolk Southern's income if the fair market value of the assets being depreciated is at least equal to 85 percent of their value for tax purposes. Were it instead determined that the fair market value was less than 85 percent of the value of the assets for tax purposes, Norfolk Southern's ability to offset non-Conrail income could be limited through the so-called "built-in loss limitation" provisions of the tax code. To our knowledge an appraisal of fair market value does not exist. Additionally, it is not clear how such an appraisal should be prepared. Fair market value determined on an asset-by-asset basis might differ from the value of the railroad as a going concern, subject to various contractual, regulatory, and legal constraints.

The Department of the Treasury has indicated that the difference between the proposed purchase price and the value of the assets for tax purposes suggests that the built-in loss limitation would apply; it has not concluded this with certainty. On the other hand, Norfolk Southern claims that it will be able to use the full depreciation deductions and has presented some materials to substantiate its claim. While this matter would probably be settled in the audit and judicial process, an assumption is necessary in order to construct revenue estimates. In the absence of any direct evidence that the fair market value of Conrail's assets is some identifiable amount less than 85 percent of their tax value, the JCT assumed that Norfolk Southern would not be limited in its use of Conrail's depreciation deductions. If it were instead assumed, for illustrative purposes, that the fair market value of the assets was equal to only 75 percent of their value for tax purposes, the revenue loss from the sale would be reduced by $0.2 billion over the 1986–1990 period (assuming that Norfolk Southern would lease equipment to allow more rapid access to built-in losses).

A second major set of assumptions concerns Norfolk Southern's agreement to pay $375 million to Conrail employees and beneficiaries of Conrail's Employee Stock Ownership Plan (ESOP). This payment will be made, under terms that are not yet final, in exchange for the ESOP's stock interest in Conrail as well as for the settlement of outstanding wage claims. The ESOP portion of this agreement, however, cannot be implemented without further legislation. Both the termination of the ESOP plan and any distributions from the plan to beneficiaries before 1991 are prohibited by current law, and S. 638 contains no provisions allowing such changes. For

this reason, the JCT has estimated no revenue effect from the ESOP portion of the $375 million.

Two issues must be resolved to estimate the revenue effect of the wage claim portion of the labor settlement: what portion of the $375 million is attributable to the wage settlement and whether the payment is deductible by Norfolk Southern. The JCT attributed $212 million of the $375 million settlement to the ESOP, assuming that it would receive the same price as the government for its interest in Conrail—$48 per share. The JCT further assumed that the resulting value of the wage settlement ($163 million) would be fully deductible when paid by Conrail as a subsidiary of Norfolk Southern. Ordinarily, such a payment would be deductible; in the context of this transaction, however, the payment, particularly if made directly by Norfolk Southern, could be construed as part of the purchase price, and hence not deductible. It is reasonable to assume, nevertheless, that Conrail would take the position on its tax return that the wage payment is deductible (whether paid out of Conrail's existing funds or after a constructive contribution of funds by Norfolk Southern).

The net revenue loss from the wage settlement is the difference between the revenues lost by deductibility and those gained by taxing the employees receiving the payments. This cost estimate treats the settlement of $163 million in this fashion. If, instead, the entire $375 million were allocated to the wage payment portion of the settlement, the revenue loss would increase by $0.1 billion over the 1986–1990 period.

Conrail has traditionally financed most of its equipment through leveraged lease transactions—transferring some of the tax benefits associated with ownership to lessors—and is likely to continue to do so if no sale occurs. Conrail, as a Norfolk Southern subsidiary, is likely to purchase and depreciate future capital additions. If Conrail's current lessors find other lessees to replace business attributable to Contrail, no additional tax revenue is raised by Conrail not leasing. If on the other hand, the total amount of equipment leasing drops and lessors increase investments in currently taxable obligations, there would be a revenue increase. In preparing this estimate, the JCT assumed that the volume of leasing would be reduced and thus revenues, increased. If, instead, total equipment leasing in the economy were assumed to remain constant, effectively increasing claimable depreciation deductions, the total revenue loss would be $0.2 billion higher over the 1986–1990 period.

ESTIMATED COST TO STATE AND LOCAL GOVERNMENTS

This bill could increase revenues to state governments by an estimated $25–30 million annually. More than 50 percent of the revenues would be collected by Pennsylvania, New York, Ohio, and New Jersey. In 1981, Conrail was exempted by law from paying state taxes until a sale occurred. In January 1985, however, the corporation voluntarily offered to begin paying taxes to the states, with the condition that they make no attempts in the future to recoup revenues forgone from 1981 through 1984. No state has accepted this offer to date, but Conrail is holding funds in escrow to pay 1985 taxes. Since Conrail is not currently paying these taxes and is not required to pay them in the absence of a sale, or base case analysis assumes that no payments would be made.

If you wish further details on this estimate, we will be pleased to provide them.

With best wishes,

Sincerely,

RUDOLPH G. PENNER, *Director.*

U.S. SENATE,
COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION,
Washington, DC, June 10, 1985.

MR. RUDOLPH G. PENNER,
Director, Congressional Budget Office,
H2-402, Washington, DC.

DEAR MR. PENNER: I have received and studied the Congressional Budget Office letter of June 6, 1985 to Chairman Danforth which estimates the budget impact of S. 638 as compared to the situation of no legislation enacted in this area.

The purpose of this letter is to request you to review the Morgan Stanley proposal and, using the same analysis, provide an estimate of its budgetary impact as compared to S. 638.

On Wednesday, May 12, the Senate Commerce, Science and Transportation Committee will conduct a hearing on the Morgan Stanley proposal. At that time, I will ask that your report be made a part of the hearing record.

If you have any questions regarding this matter, please feel free to contact me or have your staff call my Legislative Assistant, Kevin Schieffer at X45842.

Thank you for your consideration of this matter.

Sincerely,

LARRY PRESSLER, *U.S. Senator.*

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
Washington, DC, August 22, 1985.

Hon. LARRY PRESSLER,
U.S. Senate,
Washington, DC.

DEAR SENATOR: This letter responds to your request for an analysis of the budgetary impact of the Morgan Stanley proposal to purchase the federal government's interest in Conrail. We have reviewed their proposal of May 1985, as well as S. 1361, the bill introduced on June 26 by Senator Specter to implement the sale to Morgan Stanley. Excluding the tax impacts, which we have not analyzed at this time, we estimate that the Morgan Stanley proposal would save the federal government about $8 million more than the Norfolk Southern proposal, plus any receipts the government might receive from warrants to purchase Conrail stock.

There are five aspects of the Morgan Stanley proposal that would have an impact on the federal budget:

1. The proposed purchased price that would be paid by the investors for the Conrail stock now held by the federal government.
2. The savings to the government for future labor protection payments, which would be borne by Conrail under the proposal.
3. The loss to the federal government of future interest on debentures and dividends on preferred stock, which it would be entitled to receive from Conrail if the bill were not enacted.
4. The potential future receipts to the federal government from warrants to purchase Conrail stock at $48 per share.
5. The potential change in tax revenues to the federal government because of the sale.

This letter will discuss each of the first four points as they relate to S. 1361 (a sale to Morgan Stanley), and compare them to the impact of S. 638 (a sale to Norfolk Southern). We are unable, however, to address the tax impacts of the sale in this letter. That analysis would have to be conducted in conjunction with the Joint Committee on Taxation (JCT), and they are unable to undertake such an effort at this time.

Purchase price

Under the Stanley Morgan proposal, the investors agree to pay the federal government, on the closing date, a cash purchase price of $1.2 billion plus any cash and temporary investments held by Conrail that exceed $800 million. This provision is identical to the offer made by the Norfolk Southern Corporation. In both cases, CBO assumed a closing date of January 1, 1986. At the end of December 1985, we estimate that Conrail will have cash on hand of approximately $1 billion and that under both S. 638 and S. 1361, the federal government will receive a one-time total cash payment of about $1.4 billion in fiscal year 1986.

Labor protection payments

The Stanley Morgan proposal, as detailed in S. 1361, would result in about $8 million more in outlay savings to the federal government than would the Norfolk Southern proposal (S. 638). Under S. 1361, Conrail would be responsible for funding all labor protection benefits after the closing date of the sale, thereby eliminating all of the payments currently made by the federal government. S. 638, on the other hand, would require the federal government to continue payments to those individuals who are eligible prior to the sale, while Norfolk Southern and other railroads acquiring divested properties would cover payments to employees laid off after the sale. As a result, we anticipate that the outlay savings to the government from eliminating the federal labor protection payments under the Stanley Morgan proposal would be about $10 million annually from 1986 through 1990, while the Norfolk Southern proposal would save the government and $2 million in 1986, and $10 million annually from 1987 through 1990.

Interest and dividend loss

Both S. 1361 and S. 638 would cancel Conrail's debt and preferred stock now held by the federal government. As a result, offsetting receipts to the government under both proposals would be about $0.8 billion lower and net outlays correspondingly higher over the 1988–1990 period.

Warrants

The Stanley Morgan proposal provides for Conrail to issue warrants to the federal government to purchase one million shares of common stock; the Norfolk Southern proposal has no such provision. Under the terms of the Stanley Morgan offer, these warrants could be exercised to purchase the stock of $48 per share until 1995. The value of the warrants, then, depends upon both the current and expected market value of the stock. For example, if the stock rises 20 percent, or $10, or to about $58 per share, the warrants would then be worth at least $10 million to the government. In addition, warrants usually sell at a premium because the warrant entitles the holder to all the price appreciation of a stock, but requires a smaller investment to hold than does the stock. Consequently, the future value of these warrants is highly uncertain and difficult to predict. Based on analyses by various financial institutions, the likely value of a warrant appears to be in the range of, $10–$30. If so, sale of the warrants would produce additional receipts to the federal government of between $10 million and $30 million.

If you wish further details on this estimate, we will be pleased to provide them.

With best wishes,

Sincerely,

ERIC HANUSHEK
(For Rudolph G. Penner, Director).

Senator PRESSLER. The real question in my mind is, I am in favor of selling Conrail under some plan. The real question is not—this chart compares it not to selling at all, comparing it to Norfolk Southern. I would like to see the comparison with CBO, really would show the dramatic thing comparing it to selling it to Morgan Stanley or a public offering of some sort. I have written on June 10. My eloquent friend perhaps could give us an evaluation of that off the top of his head.

Mr. RILEY. No, not off the top of my head. I have to confess that I have never been able to do tax numbers off the top of my head. But the chart that you see there is a comparison of Norfolk Southern with Conrail and Norfolk Southern without Conrail.

Now, the comparison of Norfolk Southern and Morgan Stanley, those are the numbers that you have in my opening statement, but we have not completed that analysis. Again, we would be glad to share that with you. We did not have the complete basis on which to do that analysis until this morning.

It is important to recognize that Conrail standing alone over the period—my colleague, Mr. Rooney, makes a good point—would pay substantially no taxes if they would pay any taxes at all. Higher levels of profitability unquestionably generate higher levels of taxation at some point.

Senator EXON. John, thank you very much. You are the most articulate farmer we have ever had before our committee. And I thank you for your statement.

The CHAIRMAN. Senator Rockefeller.

Senator ROCKEFELLER. Thank you, Mr. Chairman.

Mr. Riley, it is my impression that the 5-year commitment on capital expenditures, which is very key to the whole question of viability, is the same as between the two offers, the Norfolk Southern and the Morgan Stanley proposals. Now, I do not know whether you would agree with that.

Second, if you would agree with that, what is the concern?

Mr. RILEY. The contractual commitment is the same, but the difference is that for Morgan Stanley that is a ceiling. They do not have the cash to pay more and pay dividends at the same time. For Norfolk Southern that is clearly a floor. The Norfolk Southern has had year-in and year-out the highest capital investment ratios in the industry. Conrail is second. I have not heard anyone suggest that Norfolk Southern would not maintain those levels.

The $500 million commitment is the same in both proposals. The difference is that under the Morgan Stanley proposal, with the dividend proposals there is no practical way they can go above $500 million and they do not propose to do so. That is about $460 million below the figure projected by Conrail management.

Senator ROCKEFELLER. With respect to the dividend question, and I share a concern on that, if Morgan Stanley or those who would make up its offer would agree, through whatever mechanism, to reduce dividend levels in the early years, would that change your view in any way either of the capital expenditure portion of this or of the general deal?

Mr. RILEY. Well, I suspect it might change the view of the investors. From my perspective, if you look at the cash flow analysis that we have done of Conrail out over the next 4 to 5 years—and I would be glad to submit that for the record; in fact, I will submit a copy now—what you will see is that there is a diminution in the cash reserves of Conrail from about $846 million down to $277 million in 1989.

There would have to be a very dramatic alteration in the dividend payout provisions to counteract that, and I seriously question whether the plan would be marketable. I have to yield to Mr. Brody on that.

[The following information was subsequently received for the record:]

CASE 1

Our Case I analysis was based upon the net income and cash flow projection contained in Conrail's Five Year Outlook for 1985–89, dated June 7, 1985, adjusted to reflect the same dividend payments and use of Conrail's cash for the purchase that Morgan Stanley included in its May 14, 1985, proposal for purchase of Conrail.

Our Case I projection is consistent with Morgan Stanley's May 14 projection, in that both assume a July 1, 1985, sale date, and use of $375 million of Conrail's cash to implement the transaction.

Morgan Stanley anticipates use of the $375 million as follows:

—$230 million to Conrail's employees for past wage concessions;

—$38 million for purchase of any ESOP stock that employees desired to sell at $48 per share (Morgan Stanley assumes that only 800,000 shares would be purchased);

—$100 million of excess cash (the balance over $800 million at closing) to the Government as a part of the purchase price;

—$7 million for miscellaneous expenses.

Our Case I projection is also consistent with Morgan Stanley's May 14 projection, by providing for dividends of $30 million in 1985 and $121 million in each subsequent year.

The only other adjustment we made to Conrail's projection, was to reduce the income from investment of cash balances to reflect lower balances after payment of the cash for purchase and dividends.

Conrail's capital program expenditures were kept at the same levels that Conrail projected. Since those levels are the collective judgement of Conrail's engineering, operations, and marketing departments, and based upon the levels of traffic and im-

plicit service assumptions underlying the traffic levels projected, we did not alter them.

CONRAIL'S JUNE 7, 1985, 5-YEAR OUTLOOK ADJUSTED TO REFLECT MORGAN STANLEY'S MAY 14, 1985 PROPOSAL

[In millions of dollars]

	Projected net income/cash flow base case				
	1985	1986	1987	1988	1989
Tonnage (millions)	182	186	190	190	189
Sources of cash:					
Freight revenues	3,206	3,371	3,541	3,688	3,809
Operating expenses	2,804	2,958	3,086	3,204	3,306
Operating income	402	413	455	484	503
Nonoperating items	55	23	36	44	45
Adjustment to interest income	(18)	(35)	(50)	(63)	(77)
Net income before FIT	439	401	441	465	471
Federal income tax	0	105	128	143	149
Net income	439	296	313	322	322
Noncash items	211	333	363	391	409
Funds from operations	650	629	676	713	731
Property, sales, etc	74	40	40	40	40
Working capital changes	(18)	(30)	(35)	(40)	(45)
Total sources	706	639	681	713	726
Uses of cash:					
Capital program	559	634	657	678	665
Less: Financing	(114)	(146)	(167)	(161)	(145)
Capital—Net of financing	445	488	490	517	520
Debt installments	130	132	137	141	145
Cash used in transaction	375				
Dividends	30	121	121	121	121
Total uses	980	741	748	779	786
Increase (decrease) in cash	(274)	(102)	(67)	(66)	(60)
Ending cash level	572	470	404	338	277

CASE 2

On June 12, Morgan Stanley released a revised version of its proposal which also contains revised projections. Morgan Stanley's revised cash flow projections also reflect Conrail's new Five Year Outlook projection for 1985–89, and adjust it to reflect dividend payments, use of Conrail's cash for the purchase and reduced expenditures for capital programs.

In these undated projections, Morgan Stanley is assuming a sale at or around December 31, 1985, dividend payments of $88 million in 1986, and $118 million in subsequent years. Morgan Stanley assumes that no dividends will be required on the 800,000 employee shares that it projects will be purchased. Morgan Stanely also projects three different levels of capital spending, none of which are as high as projected by Conrail management.

In our Case II analysis, we revised Morgan Stanley's projections to reflect Conrail management's best judgement as to the levels of capital spending required to support the levels of traffic projected. We also adjusted non-operating income to reflect slightly lower income from investment of cash balances since Conrail managment's higher level of capital spending would reduce the cash balances. In fact, as you can see in these projections below, Morgan Stanley's proposal would bring Conrail's cash down to $397 million at the end of the period.

In comparison to our Case I, Morgan Stanley gained $120 million in cash balance by showing a later sale date, but there was no way they could prevent negative cash

flow or maintenance of a $500 million cash balance, while paying the high dividend rates required to keep their investors, without reducing capital spending below the level that reflects the best judgement of Conrail's management as to what is required to keep the track, equipment fleet and the rest of the property in a condition that will provide the levels of service that are required to support the projected levels of traffic.

One of the points we should make here is that one cannot arbitrarily make downward adjustments only to the level of capital investment. As a result of reducing capital expenditures, the level of service will go down and that will lead to a loss of traffic.

To the extent Conrail must keep its dividend payments at a certain level to maintain marketability of its stock, they have limited ability to reduce them, and capital spending will be used as a variable. Morgan Stanley's three capital spending options clearly indicate that flexibility to respond to limited cash flow is likely to come from reduced capital programs rather than reduced dividends. That kind of dividend policy is reminiscent of one of Conrail's more famous predecessors. Other possibilities for providing for continued dividends could be increased freight rates.

CONRAIL'S JUNE 7, 1985, 5-YEAR OUTLOOK ADJUSTED TO REFLECT MORGAN STANLEY'S JUNE 12, 1985, REVISED PROPOSAL

[In millions of dollars]

	Projected net income/cash flow base case				
	1985	1986	1987	1988	1989
Tonnage (millions)	182	186	190	190	189
Sources of cash:					
Freight revenues	3,206	3,371	3,541	3,688	3,809
Operating expenses	2,804	2,958	3,086	3,204	3,306
Operating income	402	413	455	484	503
Other—Net	55	(2)	(5)	(7)	(15)
Adjustment for interest income	0	(1)	(3)	(5)	(8)
Net income before FIT	457	410	447	472	480
Federal income tax	0	94	109	120	122
Net income	457	36	338	352	358
Noncash items	211	329	347	365	375
Funds from operations	668	645	685	717	733
Uses of cash:					
Capital program	559	634	657	678	665
Less: Financing	(114)	(146)	(167)	(161)	(145)
Capital-Net of financing	445	488	490	517	520
Cash to Government, employees and for miscellaneous expenses	375				
Debt installments	130	132	137	141	145
Dividends		89	118	118	118
Other—Net	(56)	(10)	(5)	0	5
Total uses	894	699	740	776	788
Increase (decrease) in cash	(226)	(54)	(55)	(59)	(55)
Ending cash level	620	566	511	452	397

Senator ROCKEFELLER. But if it were, if either you or Mr. Brody were to feel that it were still marketable or if in some way it were accomplished, in spite of your concerns, that would have an effect on your view?

Mr. RILEY. Of that provision in the proposal. Let me make this point. I think that there is a dilemma here. The dilemma is this. If Conrail is going to pay out those dividends, of course there is a neg-

ative—at the level they have projected, it is a negative fiscal impact.

If they do not pay out the dividends, they do not build a market for resale of the stock, and what that does it it affects the value of the stock and the capitalization of the company, which has a very negative effect on the company's ability to go out in the private capital markets and raise capital.

It is a difficult tradeoff. It is one of the issues that drove us.

Senator ROCKEFELLER. I understand that it is a difficult tradeoff. But in it there is a fine line somewhere, and I do not know whether it has been fully described. Let me pursue one aspect.

You have today and in previous testimony been reasonably pessimistic about the so-called stand-alone viability, so to speak, of Conrail. Now, granted they have had Federal help, but all in all, if one is to look at the last 4 years I guess you could say they are in the $800 to $900 million profit level range, which is not bad.

At the same time as you have tended to put Conrail down that way, you have painted in previous testimony really quite a rosy picture about P&LE and the Guilford System, when at the same time their financial records over the last 4 years have been pretty rotten.

Is there any inconsistency there?

Mr. RILEY. There is not, because each is a different issue. First on Conrail, it made profits over the last 4 years. Without Federal support, they would have made profits in two of them. And I do not put them down. They are a very well managed company.

The key in the railroad industry, however, is to look at cash flow, not profit, because remember, the Penn Central even posted profits right up to the point where it went into bankruptcy. You apply use as a new capital investment after you apply net profit.

What I have cited as a concern with Conrail—and I will go to the other two—what I have cited as a concern with Conrail is that Conrail generates, by its own estimates, cash-flows in the low double digits even in years when they generate high profitability. That puts a significant limit on the amount of dividends that that company can pay out and remain viable.

And there are some long-term demographic factors that work against them. They are in my previous testimony, so I will not repeat them here.

As to the P&LE and the Guilford System, I have been very candid in saying I do not think the P&LE has much opportunity to survive standing the way it is absent these divestitures. However—and I think Paul McGrath said this very well in his testimony in Judiciary—that a railroad's profitability is very much the function of its access and its physical plant.

What we have done in the divestitures to P&LE is to design a system that would make that railroad profitable again. We have doubled it in size, we have given it access to five major midwestern markets, direct access, and restored the connections it needs to succeed.

That really was not a competitive fix. We designed the P&LE to avoid a future competitive problem and it is literally a custom-designed system around our best judgment on what that railroad needs to succeed.

As far as Guilford goes, I am very impressed by their financial performance. I was the former owner of the Delaware & Hudson Railroad as the Federal Government. They cut the losses on that system down from $20 million to $6 million in a single year through capital investment and better routings, and connecting that system with the two main railroads.

The Guilford System is profitable on a systemwide basis. Now, when you add in the divestitures, you have given them the same full access with reciprocal switching that the Norfolk Southern now has in all of those markets, plus access to about half of the traffic that moves West to East in this country.

And I continue to believe that those systems would have to be mismanaged not to be profitable. The difference is that there are substantial fundamental changes in the structure and market access of Guilford and P&LE that correlate to the kind of market access that means profitability.

With Conrail it works exactly in reverse. Conrail standing alone, in addition to weak cash flows, has got to face its own susceptibility of truck raiding from outside the Conrail territory, the declining traffic base that Mr. Brody referred to and a very high capital investment level.

Somebody remarked the other day, and I will have to check—I cannot say for sure this is accurate, but I am going to look—that there are more bridges in the Pittsburgh area than there are on the entire Santa Fe main line across the Western part of the country. What that means is, to haul the same traffic they have a much higher capital investment level and have to generate more cash.

So we are changing the demographics of the two regional railroads. The demographics of Conrail remain the same, and they are not good, which is why we are trying to do this the way we are trying to do it.

I appreciate that is a very good question, Senator, and I do appreciate that.

Senator ROCKEFELLER. Mr. Chairman, my time has expired. I have two more questions, but I will submit those for the record if I might.

The CHAIRMAN. Thank you.

Senator Pressler.

Senator PRESSLER. Well, the question on the CBO tax analysis has already been answered, but I think that CBO document is a very important and significant matter. Let me ask you a question and have you answer yes or no, and I think it is a fair one: If you could be convinced that an independent stand-alone Conrail is viable, would you not agree that from the point of view of basic transportation policy it would be better to have three railroads feeding the Eastern United States than two?

Mr. RILEY. The answer to that—and I am going to try and give you a fair answer, Senator, and I do not want to say either yes or no, because it is neither. It is not necessarily, but possibly, and the reason I say that—it is a function of where they go, what the long-term demographics and trends in their markets are, the kind of market access and competition they create.

I mean, one could posit that question about the P&LE as it stands today and the P&LE as it would stand after the divestitures and perhaps reach a different answer.

Senator PRESSLER. Well, a real concern that I have had very seriously is the competition issue and how it affects the southern railroads and western railroads and smaller railroads, and if you are going to be dealing with an absolute monopoly or if you are going to be dealing—and I think under the Morgan Stanley proposal as I understand it there would be more competition.

But if we are not going to have some kind of gateway protection, which is really a serious issue to Midwesterner railroads, I think it is better to have three railroads competing in the Eastern United States rather than two or one.

Let me also say, what are your forecasts? Do you share the administration's assumption about the Nation's economy in the next 5 years?

Mr. RILEY. I certainly do.

Senator PRESSLER. There was a U.S. Rail Authority projection that predicted a recession in early 1986. Do you concur with that assessment?

Mr. RILEY. Well, the value of that forecast—I do not believe there is going to be a recession in early 1986. But what that forecast does is tell you what Conrail will do if and when a recession does come, and I think you have to be cognizant of that, whether it is 1986 or 1987 or some point.

I do not think any of us would say that there will never be a recession, and the beauty of the USRA analysis is that they presumed 1986 would be Conrail's worst year and that 1988 would be Conrail's best year, and that even across that range in no one of those years could they generate enough cash to pay the dividends.

Senator PRESSLER. But in these various analyses it struck me that the Department of Transportation was agreeing in part with the U.S. Rail Authority's projections, and the folks in the White House would be interested in knowing whether you thought there was going to be a recession. I thought we would let them know about that. But you do not believe that is going to happen?

Mr. RILEY. Well, Senator, no. What I guess I am saying is this. I am frankly and honestly in my own right more of an optimist as to next year's economic conditions than they were.

What we are doing—and there is no question in periods of a high economy this company can stand. What we are doing when we look at the USRA projections is to look at what the company's performance will be over a range of economic conditions, and we might all debate in what year those economic conditions will occur.

It tells you what the impact on the company's cash is, and that is what concerned us about that. And they do not change fundamentally in the new Conrail 5-year outlook, as you can see. Profits go up, but the cash flow does not.

Senator PRESSLER. Do you believe that CSX will have managing control of Conrail if the Morgan Stanley proposal is accepted?

Mr. RILEY. Senator, I do not make that accusation. In fairness, I recognize the fact that they are a 7-percent purchaser. The question is not whether they get management control. It is a little different.

They are making a substantial investment. It is a $100 million investment and they will at some point resell their stock in theory. And I ask whether they are buying Conrail because they want it or because they do not want someone else to get it? And conversely, I ask them whether they are buying Conrail to make it a stronger competitor, as NS is, or whether they are buying it to keep it from becoming a stronger competitor?

My ultimate question is, if they do in fact believe, as they told me as recently as November, that a Conrail stand-alone publicly held cannot survive, why are they investing $100 million in it? What is the result they want to achieve?

Senator PRESSLER. You stated that there would not be diversions, as I understood it, over 2 percent, is that right?

Mr. RILEY. Over 2 percent for those Midwestern carriers.

Senator PRESSLER. Well now, would you be willing to support an amendment to that effect if I were to offer it?

Mr. RILEY. Senator, I would be willing to look at that. I do not know how one would quantify that in reverse, but if you have a way I would be happy to look at it. I do mean that.

Senator PRESSLER. If that is your position, I would think you would be happy to support a simple amendment that I might offer.

Mr. RILEY. Well, my only response to that is I would be very happy to look at an amendment because we are confident in our figures. On Kansas City, I do not know how one limits the diversion, but I would be very happy to meet with you and work with you on that.

Bilateral negotiation is the best way to do it. That is what the KCS has done and I am hopeful that that will succeed with all carriers.

Senator PRESSLER. Now, what real protection to shippers is there in the Norfolk Southern covenant about abandonments, which permits abandonments subject to existing ICC laws and procedures? What is to prevent Norfolk Southern from filing for substantial abandonments of CR lines even prior to the end of 5 years?

Mr. RILEY. The answer to that is twofold. One of them is in the inherent strength of the company, and that is where I have always argued the abandonment example is. When a company is weak in cash flow—and I can tell you this from my experience in southern Minnesota—the first thing they starve are the branch lines. Very rationally, they put their money into the main lines and the branch lines go. The financially strongest company is the best protection against the loss of branch line service.

But moreover, Conrail has had something that no other railroad in the country has had for several years—expedited abandonment authority. Stanley Crane has used it very effectively. There is very little, if any, track out on that Conrail system that can meet ICC abandonment authority that has not been abandoned, because Stanley Crane is a good manager and he used the power that he had to shed the physical plant.

Senator PRESSLER. Mr. Chairman, yesterday I received what I think is an illustrative letter from the Eastern Coal Transportation Conference, which does an excellent job in pointing out the anti-competitive problems in the Norfolk Southern offer and how it translates into higher costs for shippers and ultimately of course

the consumer. The letter goes on to support the Morgan Stanley offer because it solves this very fundamental anticompetitive problem.

I ask that the letter I received yesterday from the Eastern Coal Conference on Transportation be made a part of the record.

The CHAIRMAN. Without objection.

Senator PRESSLER. Now, is there any justification for doing the analysis of Conrail different from the analysis of the Santa Fe-Southern Pacific? What was the reason for that? I pointed to that earlier.

Mr. RILEY. I am glad you raised that. That was Dr. Pittman's comment.

Senator PRESSLER. Doctor who's comment?

Mr. RILEY. Dr. Pittman's comment.

Senator PRESSLER. Dr. Pittman's analysis for the ICC.

Mr. RILEY. We are a participant in both cases. What Dr. Pittman testified was he had used a system to analyze Santa Fe-Southern Pacific that was different from the system used to analyze all other mergers. In other words, it is the reverse.

He is not saying that Conrail was analyzed under a different system from all other mergers. What he testified to was that he had used a different system to analyze Santa Fe-Southern Pacific than all previous mergers. And Paul McGrath had testified that the same screening systems used for the CSX merger, for example, were used for Norfolk-Conrail.

Now, what he did in specific was that he took the aggregate net diversion number and he eliminated the conventional screens for intermodal product and a variety of other types of competition that he had applied in the other cases. That is what they did. So what he did in effect was produce a worst case scenario number, assuming that there were no trucks.

Senator PRESSLER. Is that for the Santa Fe Railroad?

Could I meanwhile call forward the expert who prepared this? And I am going to rebut this, too. But Mr. Chairman, I ask unanimous consent to call forward the expert from the company that prepared this.

The CHAIRMAN. Let us see how we do on time.

Senator PRESSLER. Is there an objection to that?

The CHAIRMAN. Well, there may well be.

Senator PRESSLER. Go ahead.

Mr. RILEY. OK, Senator, and I would be glad to——

Senator PRESSLER. I think it is very significant that the antitrust problem is raised under one model that is only a few pages, and using the same model that the Transportation Department uses in the Conrail, if you apply the same economic model you get this many problems. That is quite a difference.

Mr. RILEY. I just make this point. The printout from the Justice Department is a summary and it reflects bank and bank and tape and tape of computer data. If I was back as a private attorney I would be tempted to say, looking at those two piles, it is easy to distinguish who is working on an hourly fee. But I say that with all respect, coming out of that profession.

In a serious sense, if you take a no-screen, if you take a no-screen approach to the Norfolk Southern-Conrail merger or any of the

other mergers, you get a much higher number. But let me also say that those numbers are right there in the analysis because they calculate that number first. Then they begin to apply the screen. So all of the same numbers are there. And, Senator, I would be glad to submit a great deal of detail on that.

Senator LONG. If the Senator will yield, I hope we are not getting a supercilious answer here. Is there information to back those two pages up comparable to what the Senator has here?

Mr. RILEY. Yes, there is, Senator, and I would be happy to receive them, review them, and respond to them.

Senator LONG. Because if there are I think we ought to see them. I mean, I do not want us to sit here and take a supercilious answer for a serious question, and I would think that there should be backup information comparable to that pile of information somewhere.

If it is there, I think you ought to show it to us, because the inference of the question is that this thing was just glossed over in one case and studied in the other—the other merger was studied. Where is the information that backs up the two pages on the Conrail sale?

Mr. RILEY. Senator, we understand that the Justice Department has a very great amount of backup data and they have. I can testify to the way they reach those numbers is to start out using the ICC waybill sample tapes, and then they start with all traffic that moves on any portion of the country and take it through the Conrail region.

All that data is stored in the computer bank, and I have no objection to releasing everything that we have subject to agreements on confidentiality. I think I already have, and certainly it is not my intent to provide a simple answer.

My answer to it is that the same basic data bank required to produce one of those documents is required to produce the other. The difference is in how much of it you ultimately print out.

Senator LONG. Well, it just seems to me that to be fair with this committee that should be demonstrated.

Mr. RILEY. And we would be very happy to do that, Senator, and I can assure you that we have no less standards.

Senator PRESSLER. Mr. Chairman, I have requested that same information in writing, and I would like to see the Pittman analysis which, according to one private company, if you apply this produces this much.

If the Justice Department is using the Pittman economic model in the Santa Fe case and other antitrust cases in the country when they appear before the ICC, I would think they should use the same analysis, the same economic model in Conrail, and I have requested that information and I compliment my colleague for requesting it again. And I may be wrong, but I would like to see the Justice Department analysis.

Mr. RILEY. Senator, I would be glad to not only give you our response, but to ask Justice to give you a response as well.

Senator PRESSLER. When may we anticipate receiving that? I requested that some time ago. When may we anticipate receiving that so we can digest it a bit? Because if I am wrong I will say so.

If I am right, there is a dramatic difference, and I think that information should be known.

Mr. RILEY. Senator, I would not give you a deadline for an agency other than my own, but let me say I will give my full effort to turning that around as quickly as we can turn it around, and I will in fact call Justice this afternoon on it.

If I could make a point that I think will clarify it a little bit, when you do a diversion analysis you start out looking at the maximum amount of traffic that could go to or come from a common point. Then you apply a series of screens. The only difference between the two analyses—and it is a difference which is significant—is which screens you use. They use different screens.

I raise that only for this purpose, to illustrate that the base numbers in one analysis are also there in the other before they apply the screens. So I suspect the numbers are not inconsistent. It is a question of whether you accept the premise that intermodal transportation is in fact a limiting factor on price.

Now, I do not pretend to be an analyst, but that is the summation of the two as I understand it from my experience in the two cases, and we will follow up.

Senator PRESSLER. Mr. Chairman, I ask unanimous consent to insert at this point a response from the company that did that, the comments that have been made. And also I would ask that you ask for a deadline for receiving this, because I asked for it some time ago. What is a reasonable amount of time before we receive it?

The CHAIRMAN. Well, I appreciate that, Senator Pressler. I think you are right, we have to keep the process moving along with some dispatch.

Mr. Riley, how quickly can we expect a response?

Mr. RILEY. Well, Senator, the only difficulty I have is in speaking with the Justice Department. I would be prepared to take the Reebie analysis today, take it back and start working at it. If I could have the opportunity to consult with Justice, I will be happy to give you a date. And obviously, we want to move the bill at an early date.

The CHAIRMAN. We will do our best. I think that that is a fair request for speed.

Senator Ford.

Senator FORD. Thank you, Mr. Chairman.

We have been listening to anti-Morgan Stanley now for 2 hours, and I think they ought to be able to get to the table to defend themselves. I will be very brief.

Mr. Riley, do you think CSX is a well-operated railroad?

Mr. RILEY. Yes, I do.

Senator FORD. Mr. Brody, do you think Morgan Stanley is a reputable organization?

Mr. BRODY. Yes, I do.

Senator FORD. Well, we got two yesses pretty quickly, did we not?

Mr. Brody, let me ask you the difference between the public offering of Morgan Stanley and the 15 percent which is basically ESOP. Is that offer of $1.2 billion or $1.3 billion, I think you gave a few moments ago, for 85 percent of Conrail, and for the 15 percent an offer, I think it is of $48 for the stock of that 15 percent?

What kind of dollar amounts are we into?

Mr. BRODY. The $1.2 billion plus the excess cash plus the warrants, which we estimate to be in the area of $1.3 billion, is for 85 percent, which is the Government's interest.

Senator FORD. OK. Then what about their offer on the 15 percent, since you have analyzed it?

Mr. BRODY. On the 15 percent, there is an indeterminate amount which would receive the same price.

Senator FORD. Which is $48?

Mr. BRODY. Which is $48 a share. And the remaining stock would be handled in ESOP in a yet to be determined way.

Senator FORD. I thought that was in the offering of Morgan Stanley. We will get to that, then. I thought they had a flat offer at $48 to take the 15 percent.

Mr. BRODY. That is not my understanding.

Senator FORD. That is not your understanding?

Let me ask you, then, Mr. Riley, with respect to taking 2 percent away from these other railroads, is that gross or net?

Mr. RILEY. It is 2 percent in freight revenues.

Senator FORD. What does that get down to in dollars, then? Do you know?

Mr. RILEY. It will differ from carrier to carrier.

Senator FORD. That is $180 million, I thought you said a few minutes ago?

Mr. RILEY. From all carriers.

Senator FORD. Two percent profit based on high volume may be the bottom line for some of these railroads.

Mr. RILEY. Well, the difference is that when you take the 2-percent volume—and I am talking about the Midwestern carriers here.

Senator FORD. I understand. But you talked about the Midwestern carriers and then you talk about $180 million as to all the railroads. So I do not know where the $180 million starts or ends.

Mr. RILEY. OK. Two points, Senator. One, that is in the diversion analysis which we have made available. I would be happy to provide that. It breaks it down carrier to carrier.

Second, when you take the 2-percent diversion, you are taking not only inflow, that is, the money paid to move the goods, but you also reduce costs. In other words, you do not take 2 percent off the top of receipts. You also lower costs.

If the railroad is running at a margin of 1½ percent, or 2 or 6 or whatever that is, you reduce it by 6 percent of 2 percent.

Senator FORD. Yeah, but if you take its income away from it and you take its profit away from it, even though you reduce, you say, the overhead, that is not reduced down far enough in order to offset the 2-percent loss. You still have to have the same depots, you have to have the same yards, you still have to have all those things.

So your 2-percent loss is greater than the reduction in expenses.

Mr. RILEY. It would be greater than the reduction in expenses, yes.

Senator FORD. But you are taking away in this deal $180 million in gross revenue, that is your estimate?

Mr. RILEY. Uh-huh.

Senator FORD. By this deal, from all the other railroads?

Mr. RILEY. I think it is exactly $183, yes.

Senator FORD. OK. So we show a $180 million siphoning of income from the other railroads. Did I understand you to say a few moments ago you did not know anything about coal?

Mr. RILEY. Mr. Rooney is my coal expert.

Senator FORD. I thought you said you would have to ask some of the others, and you looked up here, about coal; that you were a farmer. Did I get that from you?

Mr. RILEY. Senator, I do not have the personal knowledge of coal movements that I do of grain movements.

Senator FORD. Well, you made a very, very harsh statement in a speech that you gave as it related to coal-burning utilities ripping off the consumer. I think that is your speech—the Government's point man made that statement, according to the "Traffic World" of June 3, 1985.

Apparently you know enough about coal to say that utilities who burn it are ripping it off because they are burning coal. Also, given that 22 percent of the income for railroads is from coal, which represents one-third of their profit, you ought to know something about profits and losses in railroads as they relate to coal. You ought to be a little bit less harsh on those of us who have a great coal resource in our States, and are trying to move it on these railroads, and have as much interest in it as anybody else and maybe more as it relates to the volume and the profits to the railroads.

Mr. RILEY. Senator, as a person who works with the railroad industry that is very much dependent on its relationship with coal, we have enormous respect for the coal producers.

The reference there was in Nashville, TN, at a railroad marketing conference, and I received a question on the CURE bill. And what I said was that the CURE bill, C-U-R-E—what C-U-R-E stands for depends on what your perspective is. From the perspective of the coal shippers, it is Consumers United for Rail Equity. From the perspective of the railroads, it is Coal-burning Utilities Ripping off the Railroads. And that is the point. No accusation there.

Senator FORD. But you are quoted, my friend, you are quoted, and you said you prefer to decipher the group's acronym as the Coal-burning Utilities Ripping off Everyone.

Well, the Governor of Texas was a little more to the point. He said Texans were stopped from robbing railroads 50 years ago. Now he wants to stop the railroads from robbing Texans. So there are a lot of issues here.

Now, just be a little less harsh on the coal industry, and you might get a little less harshness from this Senator.

Thank you, Mr. Chairman.

Senator EXON. You have not even taken on tobacco, have you?

Mr. RILEY. I do not smoke, Senator.

Senator FORD. How about distilled spirits?

Mr. RILEY. Sir, I am strongly in favor of distilled spirits.

Senator FORD. I got him on two of three, Mr. Chairman.

The CHAIRMAN. Thank you very much.

Mr. RILEY. Mr. Rooney said to tell you he smokes the tobacco.

The CHAIRMAN. Thank you very much, Mr. Riley, Mr. Brody, and Mr. Rooney. Thank you.

Mr. RILEY. Senator, let me add something to that. I realize I may invite a response.

The CHAIRMAN. Briefly I hope, because we have got all these other witnesses.

Mr. RILEY. I do not want to take Morgan Stanley's time.

We have over the course of the last 2 years been at many forums in which we discussed deregulation, and we talked with the coal shippers, and they talked with us, and there were many coal shippers in the audience at Nashville, and Senator, that was not only said in jest, but it was said with a laugh on my part, and I think the audience took it that way.

Senator FORD. It did not come out that way in print. When you make your speeches and you have all those ghost writers helping you, be careful with this issue because newsprint does not smile.

Mr. RILEY. I understand that, Senator. Thank you.

The CHAIRMAN. Thank you very much, gentlemen.

[The following information was subsequently received for the record:]

QUESTION OF SENATOR PRESSLER AND THE ANSWER

Question. I would like to know exactly how many FRA employees are associated with what I believe is commonly referred to as the FRA "Strike Force."

Answer. FRA's staff possesses extensive practical railroad expertise. The strike force concept represents an umbrella type organization that can call upon this expertise as it is needed on a case-by-case basis to deal with local rail problems. One individual in the Community and Shipper Assistance Staff is permanently assigned to serve as a point of contact and to coordinate strike force activities, but any FRA employee may be called upon at one time or another to use his or her special expertise to perform a specific task as part of a strike force project. We have utilized the skills of individuals ranging from the Associate Administrator for Passenger and Freight Services to the President of the Alaska Railroad.

QUESTION OF SENATOR RIEGEL AND THE ANSWER

Question. It appears that Morgan Stanley has provided important information concerning the operating plans and financial projections for their proposal. It would be most helpful to have similar information from Norfolk Southern which describes their operating plans and pro forma financial projections. Could you provide to the committee both the operating plan and the pro forma financial statements so that we can adequately compare the two offers?

Answer. Norfolk Southern provided an operating plan to the Interstate Commerce Commission (ICC), attached.[1] Norfolk Southern did prepare pro forma statements, however, they were not submitted to the ICC. The pro formas have been submitted to the House Committee on Energy and Commerce under a confidentiality agreement. I have sent a copy of your question to Mr. Claytor, President of the Norfolk Southern. I suggest that you contact his office to develop an appropriate confidentiality agreement.

QUESTIONS OF SENATOR ROCKEFELLER AND THE ANSWERS

Question. Mr. Riley, tax considerations have been an important part of the overall debate on this issue. The Committee has recently received an analysis by the Congressional Budget Office that says that the U.S. Treasury will lose some $400 million (over 4 years) of tax revenue if the deal goes through to Norfolk Southern. The reason widely given for this is Norfolk Southern's ability to shelter some of their own income with Conrail tax benefits.

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[1] The attachment was not reproducible and is in the Committee files.

—Would the Transportation Department support an amendment to prohibit this type of tax shelter, even if you might disagree with the conclusion that such a shelter might be used or available?

—Would the Transportation Department support such an amendment even if it were to cause Norfolk Southern to reconsider its participation, as they were reported to have suggested in testimony on the House side?

Answer. In response to the first part of your question, the Secretary has previously indicated that she would be prepared to not object to an amendment that would make the de minimis test inapplicable to this transaction. I want to emphasize that the de minimis test is applicable to every private transaction and would be applicable to an analogous transaction between private parties.

However, the Secretary took the position that she would not object to removing that test and the ability it gives a purchaser to gain, in a sense, a 15 percent leapfrog (from 85 percent of the basis to 100 percent) in this transaction.

Although Norfolk Southern has stated that it objects to any such amendment on the grounds that the entire sale transaction should be subject to normal tax treatment, good or bad, I do not believe that passage of such an amendment limiting applicability of the de minimis test would cause Norfolk Southern to pull out of the sale.

Question. You have cited and criticized the Morgan Stanley pro formas because you believe they show a 5% rate increase for Conrail traffic.

—What do the Norfolk Southern pro formas provide for?

—Why doesn't the Committee have the pro formas and 5 year operating plan for running the combined railroad?

Answer. Norfolk Southern has projected rate increases for Conrail as a standalone company averaging about 3 percent per year over the 1985–89 period using Conrail's 1985 Budget as a base.

The Committee has been provided a copy of the operating plan that Norfolk Southern submitted to the Interstate Commerce Commission. Norfolk Southern's financial projections for the combined system have been made available to the House Committee on Energy and Commerce under a confidentiality agreement. I believe the same arrangements could be worked out between your Committee staff and the Norfolk Southern.

Question. Mr. Riley, would you say that Conrail, or the projections for Conrail, would be better or worse if it had more coal originated or hauled on its system; for example, if Conrail could expand some of the service area in West Virginia to reach more mines, would you think that the additional coal haulage would have a net beneficial effect on Conrail?

Answer. The question of whether hauling certain additional traffic would contribute to a railroad's overall strength depends on the nature of the traffic, the density and pattern of shipments, and how the shipments relate to the railroad's existing operations, its system of track and facilities, and its fleet of locomotives and freight cars. Traffic that might not be attractive to one railroad might be highly attractive to another railroad or a combination of railroads. An increase in coal traffic would likely benefit a railroad if the traffic involved use of lines and other capital and operating systems that were well-developed and efficient for handling that type of traffic. On the other hand, if the new traffic would impose heavy additional requirements for such things as upgrading and replacing track, signaling, yards, or loading and unloading facilities, the railroad's physical and financial condition could suffer. This would be particularly true in markets that are highly competitive, and as a result shippers might not be willing to compensate the railroad for the costs of those investments.

The experiences of CSX in recent years provide telling examples of both possible situations. In the late 1970's, maintenance and investment requirements to accommodate a shift in the direction and pattern of coal movements on the Louisville and Nashville Railroad (L&N) from the Kentucky coal fields severely eroded that railraod's earnings. Service to shippers suffered, along with L&N's finances, and a combination of rate increases, advances from its parent company, and massive capital spending were necessary for L&N's operations to become financially and operationally sound again. On the other hand, with the merger of the Chessie and Seaboard Systems, CSX has been able to route coal traffic over a new connecting point between the Chesapeake and Ohio (C&O) and L&N lines at Deane, Kentucky, permitting coal originated on C&O in Eastern Kentucky and West Virginia to move on a direct route southward to the Carolinas, Georgia, and Florida. This has opened up new markets for the C&O—originated coal among Southeastern utilities which previously had not turned to that source of supply to any significant extent. Before the merger, the individual carriers had little incentive to tie their systems together by

building new connecting tracks, and the economics of the existing joint-line options prevented C&O-served mines from being cost-competitive in Southeast markets.

Increased traffic through Conrail's coal pier at Philadelphia may be one example of potentially attractive new business. However, moving West Virginia coal to Philadelphia on Conrail's lines today involves an extremely long haul northwest through Columbus, Ohio, and then east all the way across Pennsylvania to the pier. Because the Conrail routing is competing with more direct routings on Norfolk Southern and CSX from West Virginia to Hampton Roads, Conrail has reduced coal rates from West Virginia to Philadelphia, down to the same level as rates from Pennsylvania mines that are several hundred miles closer to Philadelphia. Conrail has done this to improve utilization of the recently modernized and expanded coal pier and other Conrail facilities in Pennsylvania that are operating considerably below capacity. Despite all that Conrail has done, relatively little coal traffic moves over the Conrail route from West Virginia. As long as the traffic remains light enough that the incremental costs of carrying it are low, the railroad can afford to charge low rates. Within Conrail's present system and rate structure, however, the West Virginia traffic, on its own, is unlikely to be highly profitable for Conrail.

Merger of Norfolk Southern with Conrail would make movements of West Virginia coal to Conrail's Philadelphia pier both more efficient and more attractive to the railroad, by reducing the distance and circuitry of the movements and instead putting the traffic on a direct, single-line route through Hagerstown. With that option available, additional coal traffic moving onto Conrail lines from West Virginia mines would be significantly more beneficial than it is today. Again, the difference is in the way that the traffic fits the structure of the individual railroad's lines and the pattern of its operations.

Question. Given your statements about Conrail and its viability, I am interested to know how you would assess the financial viability of the two other major Eastern railroads, the Norfolk Southern system and the Chessie system?

Answer. The Norfolk Southern (NS) and the CSX are both well run and financially sound holding companies with a long history of profits. The NS has assets of $8.7 billion as of December 31, 1984, and earned a profit of $482 million for 1984. The CSX had assets of $11.6 billion as of December 31, 1984, and earned a profit of $465 million for 1984. While both companies are profitable, neither earned profits at the level to be considered revenue adequate according to the ICC standard. Both companies are well thought of in the investment community, maintain solid credit ratings, operate in established markets, have efficient, well maintained operations and strong management organizations.

Question. Mr. Riley, Norfolk Southern had about 100 million tons of coal movement on its system in 1984 and Chessie about 175 million tons; can you tell me how this level of coal traffic contributed to the profitability of the two railroads?

Answer. The most recent figures published by the Interstate Commerce Commission indicate that Norfolk Southern originated approximately 112 million tons of coal last year, while CSX originated approximately 171 million tons. Within CSX, the Chessie System railroads accounted for 96 million tons of the total coal originations.

It is not possible to trace the revenues from a particular railroad movement or commodity down to the bottom line of the parent corporation's income statement. It is true, however, that the railroads now operating as part of Norfolk Southern Corporation and CSX Corporation have historically relied to a relatively large extent on coal for both their traffic and revenue base, and that is still the case today. In fact, it appears from the financial returns reported by the two corporations in recent periods that when coal loadings turn downward, overall income also suffers, and when coal traffic rebounds, corporate earnings generally follow.

Question. Mr. Riley, would you tell me what mix of traffic would best make Conrail a viable railroad? How does such a hypothetical mix of traffic compare to what currently exists on the railroad?

Answer. To assure that the present Conrail system will be viable in the long run, it must be integrated into a larger system that is not tied entirely to the Northeast region that Conrail now serves. Conrail needs access to traffic that will help balance the cyclical downturns in the basic industries that predominate its present traffic, it needs to become less dependent on a single territory, and it needs to lengthen its hauls to improve the efficiency and profitability of its operations.

Achieving profitability is not simply a matter of building volume in certain commodities or changing the proportionate mix of commodities. Instead, what Conrail must do is to broaden its traffic base considerably beyond the territory and range of movements that it now serves. Conrail's weakness is largely a result of the geography of its system and service area. At present, Conrail is extremely sensitive to the

economic downturns affecting the basic industries of the Northeast. The larger the service area of a railroad, the less susceptible it is to economic and financial losses in a regional downturn such as has affected the industrial heartland which is the core of Conrail's present service territory.

Conrail is also the victim of the short length of haul it can handle on its own lines. Long single-line hauls generally are far better revenue generators for a railroad than the short joint-line moves that characterize Conrail's business. Much of the traffic available to Conrail moves for longer distances than Conrail can handle on its lines alone; the majority comes from locations outside of Conrail's service territory, and must, therfore, be originated by carriers other than Conrail. The originating carrier typically exerts greater power and generally receives a more favorably diversion of the joint-line revenues from a movement than the terminating or "bridge" (intermediate) carrier—the roles usually played by Conrail. Therefore, Conrail does not earn attractive profits on much of its traffic.

Furthermore, the necessity for Conrail to interchange the majority of its traffic with other carriers adds to the time and expense of the movement, as well as the difficulty of establishing and maintaining a consistent delivery schedule. In contrast, the well-developed highway network paralleling most of the rail lines in the East permits truck movements from origin to destination without any interchange between carriers. Motor carriers have therefore been able to avoid the added delay and expense of joint-line service, and consequently to win substantial volumes of traffic away from rail, on the basis of their greater speed, efficiency, and service reliability. In fact, as a result of the Northeastern railroads' chronic financial losses, the operational problems in interchanging traffic, and the continuing interrailroad disputes that they have provoked, a significant amount of traffic originated in the Southern territory that was once delivered to Northeastern railroads now moves by rail only to the northermost interchange point, and then is loaded onto trucks for the final leg of the trip.

Although to some extent Conrail has been able to improve its share of the revenues on North-South traffic since 1980, and its program to reduce costs and streamline operations has resolved many of the earlier problems with rail service quality, Conrail is still held back by the same geographic situation that has plagued the Northeastern railroads for many decades. Through merger with Norfolk Southern, Conrail would be able to offer single-line service from the major originating markets in the South directly to the destination markets, without the problems of delays at interchange points or incompatibility of scheduling and operations between the individual railroads. The shipper could rely on a single railroad for rate quotes and service and delivery schedules. Whereas on its own, Conrail cannot generate an attractive enough traffic base to assure its long-term viability, as part of a single-line system to the South and Midwest created by linkage with Norfolk Southern, Conrail will have the range and type of traffic that will be able to sustain the railroad through the ups and downs of the coming decades.

Mr. CHAIRMAN. Is Senator Heinz here?

OK. Mr. Saunders.

I would like to say this first about Morgan Stanley, because obviously this is a very hotly contested issue, the future of Conrail. There are strongly held views on both sides, pro and con, the Norfolk Southern sale or the Morgan Stanley proposal. On something this big and in this kind of forum, I think it is natural that the positions would be stated with great vigor, and the proposals that have been made and analyses that have been made by Morgan Stanley would be subject to hotly stated contention. But with respect to the reputation of Morgan Stanley and its ability, I have absolutely no question whatever.

When I first got out of law school I worked for Morgan Stanley's law firm, and this was some time ago, in the early 1960's. But I can remember those dealings very, very clearly. I remember one case where Morgan Stanley was an underwriter, I think, of a secondary stock offering of a fairly major corporation, and it turned out that after the stock was sold, the company just really was sour, and it was something that Morgan Stanley did not know about at the time.

But without any legal compulsion whatever, it decided just for the sake of maintaining its own reputation and its relationship with people that it had done business with that it had a special obligation to go to that company and just make it right, and it did, and it spent all kinds of time and effort and manpower trying to work out the previously unknown but very serious business and economic conditions of that particular company.

So, Mr. Saunders, I am sure that you have heard vigorous comments about your proposal, but there is no doubt in my mind that it is a serious proposal. I may or may not end up agreeing with it or disagreeing with it. I do not think I am going to be agreeing with it unless you are extremely persuasive. But there is no doubt in my mind that it is a serious proposal and that every bit of the thought that has gone into it has been something that has been carefully done and with all of the integrity of Morgan Stanley behind it.

Senator PRESSLER. Who else is at the table? Could you identify yourselves?

STATEMENT OF THOMAS A. SAUNDERS III, MANAGING DIRECTOR, MORGAN STANLEY & CO., INC., ACCOMPANIED BY JAMES RUNDY, MANAGING DIRECTOR; ANDREW PETERY, RAILROAD ANALYST; JOHN CHAPOTON, FORMER ASSISTANT SECRETARY OF TREASURY FOR TAX POLICY

Mr. SAUNDERS. Yes, let me do that

I have with me to my right, Mr. Rundy, James Rundy, the managing director of Morgan Stanley. Next to him is Mr. John Chapoton, partner of Vinson & Elkins, former Assistant Secretary of Treasury for Tax Policy; and to my left I have Mr. Andrew Petery, who is a railroad analyst with Morgan Stanley.

Mr. Chairman, I want to thank you very much for the opportunity to appear before this committee. It may be a little unusual that we are back here, but I suspect that this very proposal would not be on the table if you personally had not in effect at the last meeting told us when we left the room to put your money where your mouth is, and I felt that was a worthwhile challenge.

The CHAIRMAN. Did I put it that way?

Mr. SAUNDERS. No, you did not. It was much more elegant than that. Upon analysis, after a week of looking at it, that is what we concluded you meant.

I guess you have offered the second challenge in this series by saying that you are not sure you can be convinced unless we do a very good selling job, and we take that in the same manner in which the other challenge was issued.

I have a brief opening statement, and I may actually stray from it some because we have had a lot of questions today that have been raised, questions about our proposal, questions about Conrail's viability, questions about the new projections that have been put forth by Conrail as of last Friday and those implications.

I suspect that we will be unable to answer today in the time that we have allotted these questions as thoroughly as they should be answered, but I will say that we stand prepared to address any and

every question that has been raised and to attempt to give you the best possible answer that we can on any question.

I would like to request that Mr. Chapoton be allowed time for a brief statement in response to certain questions related to the tax issue. That is extremely important, and we think it has to be addressed as thoroughly as possible.

I would like to start today by saying that we are cognizant of the process that has been so ably administered by Secretary Dole which has resulted in the recommendation to the Congress of the Norfolk Southern offer to acquire Conrail. In initiating the sale to private sector ownership, the Secretary laid out a series of concerns, and one of the concerns was rightfully that the Government be free of risk, present or future, resulting from such sale.

We share the concerns of Secretary Dole, and our proposal attempts to respond to each of her concerns in order to ensure that the interests of the taxpayer, the Government, the railroad, the communities, and customers it serves are all protected.

Our objective, simply put, is to work with Secretary Dole and the Congress to ensure the taxpayer of the best possible return on what is a substantial investment by any measure, to ensure the long-term financial viability of Conrail, to better meet the interests of its employees, and to continue a healthy, competitive railroad.

I would like to just touch very quickly our proposal, and I will try to keep this in summary form, and we can answer questions in as much detail as possible.

First, we are offering $1.2 billion in cash for 85 percent of Conrail. This includes none of Conrail's cash in that $1.2 billion, and I am going to come back and talk in some detail about the use of Conrail cash.

We have said that there is an incremental $600 million in present value of additional tax revenues when compared to the Norfolk Southern. Last Friday on June 7 we received a revised set of 5-year projections from Conrail which calls for higher earnings over the 5-year period. The more financially viable Conrail may be able to use some of its tax benefits more effectively, and this may reduce this incremental gain somewhat.

We have not completed our tax analysis, but we will make it available as soon as possible, and we will have Mr. Chapoton address this issue today, including the conceptual aspects of it, and the numbers that we have been able to determine thus far.

I would like to make one point here. This analysis cannot be completed with the type accuracy that this committee needs until the Norfolk Southern operating plan is produced. The only plans and the only projections that seem to be in the public forum, subject to scrutiny and subject to investigation, are our plans. Norfolk Southern must have developed an operating plan on the acquisition of Conrail. It is the only way that we can get behind the numbers and truly measure the tax impact and implications of this merger.

Now, we also offer 1 million purchase warrants, and those warrants provide the opportunity for the Government over a 10-year period to acquire Conrail shares at $48 a share. It was indicated earlier that they may be worth $20 million. The fact is until you can reach the assumptions with respect to market price to volatility of Conrail stock when it is trading in the public market, you in

fact cannot come up with a precise number as to the value of those warrants.

I suspect if you think that the Government will have an opportunity to exercise or sell those warrants over this 10-year period, they are worth something more than the $20 million, and they may in fact be worth significantly more. We offer the excess cash, over $800 million, to the Government in exactly the same form that Norfolk Southern does. There is not a single difference in terms of that excess cash.

How we calculate the excess cash for the Government is exactly the same as Norfolk Southern. So there is no difference, and there can be no difference on that particular point.

Last, to the extent that the investors realize gains from the purchase of these shares, the Government will obviously share in that through tax receipts related to those gains.

Now, a couple of other points on the plan. We have the public interest covenants that Norfolk Southern has in essentially the same form or equivalent. There are a couple of modifications which reflect absolutely nothing more than they have to be different for a publicly held company than they do a private company. We are essentially stepping into the shoes of the Government, taking all of the market risk with respect to the future sales of Conrail.

At the end of the period, this group will sell off its shares and own no more than 40 percent, and of course, it could sell itself all the way down to zero, and no investor, either in this group or in the public market, can own more than 10 percent of Conrail during the 5-year period.

These are self-imposed constraints. No one has asked that we have these constraints. We have done them so we can meet the objective of actually doing a public offering and putting this back into the private sector and into the general public's hands. No one should look at this group of investors as anything other than a group of very sophisticated investors who are providing an interim step in the transfer of Conrail to the public marketplace.

With respect to the plans and labor, we will respond to questions here. It can get a little complicated, but basically we are offering a package that is very flexible—is worth in our view $440 million—and it is composed of two parts essentially.

We leave the ESOP outstanding. We leave the 15 percent that the past and present employees and holders, beneficial holders of that plan own in their hands. We do not force out the employees. We have offered them an option. It is up to them to determine where we, using Conrail cash, would offer, to the extent there is some cash available, to buy shares from them at $48 a share.

Now, the point I would like to make here is that is an option. We do not care if they do not sell a single share to us. We would like to have labor as a participant in Conrail. We would like to have them a partner with us in the ownership of this railroad. It is not a requirement, nor do we want to force them out of any equity ownership. We want to provide them liquidity, and that is a form of giving them $48 a share, which is the same as the Government receives.

We are using Conrail cash, $230 million, to settle past wage claims with labor. We have also offered as an alternative, if they

would like to take that cash or some portion of it, put it in a trust fund, stand alongside the rest of us as investors. We would be happy to have them buy more of Conrail. It is simply using a cash payment that is made to them in settlement of their wages, to join us as an investor.

We propose that labor have two representatives on the board of directors, and we have had discussions with them as to the procedures for selecting those board members and believe it is satisfactory to them on at least that point. We surrender the past NOL's and ITC's in the exact same form as Norfolk Southern. That should be of no question.

The net operating losses and the ITC carryforwards are off the table. We are identical in that sense. We have no debt to Conrail. This is all common stock. There is no preferred, and at the end of this process, Conrail will have one of the strongest credits in the railroad industry, and we will come back to that later as we talk about the so-called deep pockets.

Now, if I can talk about the investor group for a moment, first the question was raised earlier as to the firmness of these commitments. These are firm commitments until the end of the year, which is precisely the time that the Norfolk Southern proposal expires. They are firm commitments in the practice of Wall Street.

Morgan Stanley did the private placements for the Trans-Alaskan Pipeline. We have done the private placement, the largest private placement for AT&T, $1.3 billion or $1.4 billion, and we arranged in defending Philips Petroleum the private placement of debt with respect to that particular transaction.

The firm—the commitments we have in the practice of Wall Street are firm in every sense of the word. In fact—and I will not take time now—we in our proposal submitted to the members of this committee have compared side by side the commitment of Norfolk Southern and these investors. In fact, upon close examination one may find that that commitment is no firmer and may be slightly less.

Now, it was finally indicated earlier that basically that is not a question. There was very little difference as to Norfolk Southern's ability not to meet this commitment or ours, and it is all well and good to look at it that way. I am here to tell you that these are firm commitments, and if 10 days from now someone said we will sell you the railroad, we will be there with the $1.2 billion.

Now, we have increased this list. I am not going to go through the additional names. There are now 32 investors. There were 25 when we announced this offering on May 14. They are sophisticated. If one looks through the list, you realize that they have an unparalleled cumulative experience in investing in railroads.

They have in many cases their own analysts. They have gone out and ridden the rails of Conrail. They have interviewed management. For anyone to suggest that Morgan Stanley can in any way lead this group of investors into an unsatisfactory, nonfinancially viable Conrail, an unattractive investment makes no sense. They are fully capable of analyzing this investment on their own and just as capable in many instances as we are.

No investor has more than 7.1 percent. We have already met our 10 percent upper limit with respect to ownership. CSX—people

have described CSX as having organized this transaction. They have gone so far as to say that we have been the shill for CSX. The fact of the matter is that CSX did not organize this effort, they did not call us, and we did not call them as the first investor.

There is no question that they have their own interest, and they can speak to that. In this particular transaction, they are nothing more than a financial investor. In fact, they are considerably less. They will put their shares in a trust and have no right to vote those shares. They will have no right to participate in management in any way. They will have no representation on the board.

They will have no right to appear or be part of any of the investor group committee. They will have nothing to say about when the shares are sold or the price at which the shares are sold. They are the most disadvantaged investor in the entire group and obviously have no ability to influence this company.

Now, Morgan Stanley and Goldman Sachs and Shearson Lehman Bros. could sit before you for a month, and we could debate the financial merits of this transaction, and all of us would drag out someone else's study that indicated exactly how Conrail is going to perform through projections. In fact, the firm commitments of this group says it all. This represents in our view the strongest testimony to the economic viability of Conrail and to its future as an independent transportation company.

There is a saying in our business, and I think it best sums up this situation: The market has spoken. It has indicated a willingness to participate. That is no longer an intellectual exercise. The money we have and are prepared to put it on the table.

In fact, we have investor interest that exceeds the $1.2 billion by something in the area of $300 million, and demand continues to come in, and I suspect within the next 2 weeks we will add more to this investor group, and CSX and others will go down further in terms of their equity participation.

Now, viability. Mr. Petery is with me today, and when we come to questions, I would like him to answer those with respect to the viability of Conrail. As investors with money on the line, we are convinced of Conrail's long-term viability. Our reasons are quite simple and borne out by the company's performance.

Conrail has and will control its costs while reinvesting in new equipment and property to maintain itself in its currently excellent property condition. In its territory, and I think this goes without question, it enjoys the benefit of the most efficient plant. Anyone that has been on this railroad will attest to that. It has surplus equipment. It has the best labor productivity of any road in this area.

On the other hand, if it is attached to its competitor, Norfolk Southern, everyone including Congress should question the future viability of the Chessie System as well as the viability of the Grand Trunk, the Milwaukee Road, PL&E, Gilford, Kansas City Southern, C&NW, Santa Fe. It should also address the injury to the Missouri Pacific and the Southern Pacific. This is due to the massive competitive impact of a Norfolk Southern-Conrail merger.

We would liken this, and if anyone can say that combining these two roads has no impact on labor, we are flabbergasted. We do not understand, if you had resolved the Chrysler problem by folding it

under General Motors and then say that that would have no economic impact on Ford or no impact on labor, it would be similar to saying that the merger of these two roads does not have those type impacts.

It seems to us it is clear on the face that that is not true. We believed Conrail's viability before we got the recent projections. A preliminary analysis convinces us that the company is even better than our initial view. If we meet the capital expenditure levels that Norfolk Southern has indicated that they will maintain plus paying our dividend, Conrail will have between $1 billion and $1.5 billion at the end of 1989, and we will get into that in as much detail as this committee would like to.

We can pass all the covenants, and I will address those covenants as to how they reflect and operate on us versus Norfolk Southern.

Now, if I may, I would like to set a couple of points straight. It seems to be one of the most confusing areas with respect to this transaction—the use of Conrail's cash. Let me make the first point. Norfolk Southern is acquiring 100 percent of Conrail. When the dust settles, they will own the entire company, lock, stock and barrel. We are acquiring 85 percent. We are paying $1.2 billion for 85 percent. The balance is being held by the beneficial holders of the ESOP. No investor will be in a position to own more than 10 percent and to exercise any business or operational control.

So we first have to understand who will own Conrail when the dust settles. One is the general public because all this group of investors is doing is going to turn it over to the public. And the other is Norfolk Southern.

Now, what does that mean about cash? Yes, we do suggest that we use cash. We suggest that Conrail pay labor for past wage settlements $230 million. We have suggested that if labor wants to sell us some of their ESOP, that they will use some cash. We are indifferent as to whether they sell us a single share. It is up to them.

The Norfolk Southern says it will use $375 million of its own cash, and that is right. They will show up at the closing and pay $375 million out of some checking account that says Norfolk Southern. When they leave the closing, they will have acquired $800 million-plus in Conrail's cash.

They will own it all, and immediately after the closing, it is not a question of whose $375 million, they will then have that cash. They can replenish it. They can use it to run their business. And in fact, if they choose not to pay themselves a dividend—and remember, they control this company—the cash covenant does not even operate. There is no requirement to keep any cash in Conrail. It is theirs. They can run it through their whole system, and they can operate this company with that cash.

It is very important to understand that subtlety. There is nothing wrong with what they have said, but what they buy for that $375 million is an awful lot of money.

Now, the covenants, who do they really operate on? Who suffers with these convenants in the sense of making or guaranteeing behavior? I have just said if they choose not to pay a dividend, they do not have a cash covenant, nothing to stop them from moving that cash anywhere they want to. There has been a lot said about

capital expenditures. All that has been covenanted to by Norfolk Southern is the intention of we will have to spend $500 million or with board approval we can only spend $350 million.

And I would like to talk about how they can satisfy that. You can buy rolling stock from Norfolk Southern, and travel on any part of the system. You can buy computers, and they can be utilized anywhere in the system. Spending $350 million and meeting a capital expenditure by Norfolk Southern will be the easiest covenant it can possibly have, and it does not have to be on equipment that is used in Conrail.

We have to spend every penny on capital expenditures, and it does not go anywhere else other than Conrail. Not a single investor, no one can put their hands on the cash, nor can they put their hands on any of the equipment, nor do they have anything to say about the capital expenditures. We can pass the test, spending $500 million, with flying colors. I said if we spend $500 million a year for the next 5 years, we will have $1 billion in cash at the end of 1989.

If we go out to the level that the company had suggested that the capital expenditures should be, which is in the area of $640-$650 million, we can virtually reach that test. If we fall shy of that, it is by—out of $3 billion, the $3.2 billion, it's in the area—it's less than $200 million out of a $3 billion program put before this committee. That is not a problem.

There has been a lot of talk about can CSX get control of Conrail, can CSX get control, can anyone else get control and strip and take this railroad apart? The fact is that if anyone has an opportunity to take this railroad apart, it is Norfolk Southern.

At the end of 5 years, when the covenants are gone, Norfolk Southern owns this railroad and they can dispose of it as they see fit. If anyone else attempts, in a publicly held Conrail—remember, at the end of five years no one will own more than 10 percent—it is impossible. Not Norfolk Southern—and by the way, they can come in and own 10 percent—not CSX, not anyone else.

If they in fact do own it at that time or have a position, they would have to go into the public market, acquire control, they would be subject to the ICC and other regulation. It is much more difficult to dismantle this railroad from a public ownership point of view than it is for 100 percent ownership.

In conclusion, I would just like to say that we appreciate a great deal having the opportunity to present this proposal and to make these comments. This is an alternative that did not exist when this committee acted before.

It does not have the public policy problems involved in Norfolk Southern. It does not involve thousands of job layoffs. It does not involve shipper dislocations. And it does not upset the delicate balance in the railroad industry as it relates to the entire infrastructure of this business across the Nation.

It does result in a viable Conrail, and I believe the best testimony of that is the fact that this group of investors is willing to invest $1.2 billion for 85 percent. It does preserve rail competition in the Northeast and the Midwest. And it does, on any basis, provide a higher financial yield to the Government.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Mr. Chapoton, did you have a comment or two to make?

Mr. CHAPOTON. Yes, Mr. Chairman, if I could. I would like to take a brief moment to respond to some of the points made on the tax considerations because I think they are quite important.

Just to set the matter in perspective, let me enumerate that we are looking at three elements of the tax differential. The first—and I think they were all three were mentioned—the first is the depreciation and investment tax credit. I think Mr. Riley is correct that the difference there is the timing. A Norfolk Southern owned Conrail will use them faster than a stand-alone Conrail.

I would mention that he said that there would be faster utilization in the Norfolk Southern context, and suggested that that went to the viability point, that meant that it would be a more viable active income-producing railroad.

I think that is not quite correct. The point is that the deductions and credits will be utilized because they will be on a consolidated return and because if Norfolk Southern owns Conrail, it can augment Conrail's income. It can frankly shift income into Conrail and make sure that deductions and credits are utilized. A stand-alone Conrail, of course, does not have that option. It cannot do any type of tax sheltering except to the extent leasing is available. I will return to that in just a minute.

The second tax element is the tier II tax, the shift in employment, and the resulting decrease in tier II taxes. The third is the allocation of the $375 million amount that Norfolk Southern will pay partially in wage settlement claims and partially in purchase of ESOP stock, and to the extent it is allocated to wage claims, that it will be deductible and thus reduce future tax revenues.

Mr. Brody stated that their calculations had estimated the present value of the future tax-revenue loss to be $30 million. I believe he was referring specifically there to the utilization of credits and depreciation.

He pointed out they were utilizing the old Conrail numbers. They have not had a chance to run the calculations on the new numbers. We have done the same calculation. We have come up with a present value loss to the Federal Government of $366 million.

We, by the same token, have not run the new calculations, but most important, we have released our numbers. We have not seen the numbers on which their calculations are based. We have not seen the Norfolk Southern calculations, so we really do not know how they arrived at the $30 million present value.

CBO, of course, has done analysis. They do it only during the budget period and only in absolute dollar terms, not in present value. They calculate a loss in future tax revenues from the tax credits and depreciation of $350–$370 million from the years 1986 through 1990.

As I said, the point that we have not done the calculations on the new Conrail projections is correct. We are doing some calculations and we certainly will supply those to the committee.

Also, the point was made that the possibility of tax leasing must be taken into account on a stand-alone Conrail. I think that is also correct, and we are doing that analysis on the new numbers as

well. I would point out that none of the carryover basis can be leased. That is the $3 million that everybody seems to agree is the basis of the Conrail assets on the date of the sale.

You cannot lease any of that. So when we are talking about tax leasing, it is just new investment in rolling stock and other equipment. Special purpose structures, track for example, would not be subject to leasing.

I think most important on that point, however, the CBO analysis does assume full leasing and does conclude that the number over the next 4 years is the $350–$370 million, taking fully into account leasing and, by the way, they informally indicate that they have not studied the new Conrail projections, but have some familiarity with them and do not think they will change these estimates.

I could not see the chart that Mr. Riley used here, but I think he did the same thing we are talking about doing; that is, you do look at a present value; you do look at loss years; and when the losses occur, you bring it back on a present value basis. If we can see those numbers they used, we certainly can see where our differential is.

But there is certainly a difference. We are talking about the same numbers, $366 million, and he is talking about $30 million.

On the job loss point, we are assuming a shift in railroad employment, a shift out of railroad employment into other sectors of the economy. We are not saying that the job loss means higher unemployment, but simply a shift in employment, and I take it from their testimony that all parties agree that if that shift occurs, that the tier II railroad retirement fund does suffer. We asked the Railroad Retirement Board to run those numbers assuming 10,000 job loss out of railroad employment. They come up with $1.9 billion through the year 2000.

We adjusted that for New York Dock protection and for income tax offset, since employers would have a smaller income tax deduction if they don't pay the tier II tax, and came up with a present value on that score alone of $245 million.

We have not run the analysis, and I take it they have not either, of the effect of the President's tax reform proposal. I would think it would reduce—if the Treasury's proposal as it now stands were adopted by the Congress, it would reduce the differential but I would want to examine that condition very, very closely.

And, finally, the so-called capital gain tax shelter. I think that point is a little misleading. It had earlier been argued before the Ways and Means Committee that since a stand-alone Conrail would have negative earnings and profits going into its first taxable year, any dividends paid out would be tax-free, and that offered an opportunity for tax shelter.

We responded by saying we will put $500 million of E&P in at the outset so that all dividends in the early years would be indeed taxable as dividends. We think that would be the case anyway, because the rule is, if you have earnings and profits during the year in which dividends are paid, those payments are dividends and are not a return of capital, without regard to whether earnings and profits are earned before or after the date of the dividend.

But to clarify that, we would put $500 million in as earnings and profits at the outset. Now, it is pointed out that the corporate

shareholders receiving a dividend will get an 85-percent dividends received deduction. That is true, but that is no more of a tax shelter, of course, than any other corporate investor holding stock in the economy.

The rules are that a dividend received by a corporation is entitled to 85-percent dividends received deduction. So that is, I think, not properly classified as a shelter item.

I believe those are the main points, Mr. Chairman.

The CHAIRMAN. Thank you, gentlemen.

First let me say that with respect to this panel and all the other witnesses, several Senators, and possibly myself included, would like to submit some questions in writing along the way, so if you could answer those.

Let me ask just one big general question and ask you to comment on it. My concern is the long-term health of whatever is left, that is, the long-term health of Conrail, nothing else.

Well, I won't say nothing else. I mean obviously employment opportunities and so on, and if we can make more tax revenue, fine. But it seems to me the basic mission of this committee is to try to preside over the defederalization of Conrail in a way which best assures its long-term health.

Now, if Conrail is owned by outside investors who are not in the investment because they are in the railroad business, but are in the investment because they want to make money, I mean I guess the railroads do, too, but they have a more long-term commitment to the railroad, it seems to me.

And if there is an understanding that dividends will be paid in the amount of $120 million and on 8.4 percent yield, which would be much greater than any other railroad, and if there is no understanding of any future commitment by these investors to put more in the railroad if times turn bad, if there is a recession, if there is a decline, I don't understand how the railroad is in a stronger position.

It just seems to me that high dividends, plus a payment by Conrail to the employees, without any infusion of new money from any other source, like Norfolk Southern or anything, else, is bound to leave it in a weaker position than if we went ahead with the Norfolk Southern deal.

It also would appear to me that something has got to give if you are paying money out in dividends. Unless there are just boom times, what gives? Well, the rates go up, and it is my understanding that your proposal does include an increase in rates or people are laid off, and it is my understanding that your proposal anticipates layoffs. I know there is a disagreement between you and Norfolk Southern as to how many people would be laid off under Norfolk Southern. But with your proposal layoffs would occur of 1,500 per year for what, 4 years or so?

So something has to give, it would seem to me. And maybe I missed something, but it seems to me that you have offered a very attractive proposition in which everything is rosy. I used to believe that when you are told something is too good to be true, it is.

Mr. SAUNDERS. Well, Mr. Chairman, if I may try to respond to that, let me say first that these investors are in this for a profit and they should be.

Second, the investor profile, when the dust settles, of Conrail will be no different than the investor profile of Norfolk Southern. If you are going to ask a question as to whether an independent Conrail can survive with public ownership, the same question should be asked of Norfolk Southern, of CSX, the Burlington Northern, or anyone else.

There is no one there that has made or purports to make a commitment to those roads in the sense that we are talking about a deep pocket.

The CHAIRMAN. Can I just interrupt. You are doing very well, but let me just say this. I think that what we are seeing with all of these corporate takeovers is really a national trend of milking corporations, of getting into corporations that have existed for a long time and just milking them, taking out all the cash you can take out, and selling off assets.

So it does not impress me that ultimately there are stockholders behind everything, I guess, but when there is this sort of change and when people are in it not to run a railroad, with no experience in running railroads, no stake in running railroads, just to get out the cash, that is a different situation than is the situation where there is an ongoing railroad that is interested in its own health and the relationship of Conrail to the health of the Norfolk Southern.

Mr. SAUNDERS. Mr. Chairman, first let me say there is an ongoing railroad. It is operating, and it is operating very well. It is wrong to assume, I think, that this railroad is—that Norfolk Southerns's commitment to the railroad business is different than Conrail's commitment. Conrail is a railroad, and it is committed to the business and it is a very efficient railroad. It has got the best plant, best plant and equipment of any railroad in this country today.

I think you have to come back—if you want to talk about stripping cash out, the only person that can strip cash out of Conrail in this transaction is Norfolk Southern, not the public shareholders. They can't take the cash out. They are limited by covenants; they are limited by an ownership provision that stops them at 10 percent. They have no way to disassemble this particular railroad.

Norfolk Southern can take the railroad down and strip it down to its most efficient parts. They can take this railroad apart. And I guess where I am having a problem is, I do not understand why that—by Norfolk Southern saying we are in the railroad business and we have a commitment. They don't covenant to spend one extra penny on this railroad, other than the capital expenditure covenant. There is no covenant to make a contribution.

Their track record in the East with respect to railroads would not support the fact that they will step in and bail this railroad out. They can take the cash out; they can use the rolling stock. I think you have to condemn the whole public ownership system to say that a privately held or publicly held Conrail is in a position to be taken apart or stripped down.

It has access to the capital markets, and when we talk about commitment, Norfolk Southern or CSX, they have no deep pocket behind them other than the capital markets, other than the equity and debt markets and their access to capital which is not where someone reaches in a pocket and gets it. Their access is based on

their creditworthiness, their operating performance, the willingness of investors to put up money and acquire an interest.

The CHAIRMAN. What commitment would Morgan Stanley have to the long-term future of Conrail?

Mr. SAUNDERS. We have perhaps one of the most important commitments. We would have an investment and we would attempt to protect that investment.

I think if you ask that question of the investor group of investors, you will find if we get caught in a downturn, if we have to cut dividends, the board of directors in our proposal can cut dividends. We can protect that.

These investors have got to protect their investment. They are not stepping up and putting $1.2 billion on the line just for a ride for 6 months. They could own this railroad for 5 years.

Now, that is not the proposal, but if the market conditions prevented them from selling this, and they take that risk, I don't think you will find one investor in that group that would not have a commitment to protect that investment. I mean our incentive, if you think about it to make sure this is a viable road, is as great as anyone's. There are really two people that have the same commitment to the viability of the railroad that get hurt financially: investors and employees.

I mean it has to work for us, in our interest, in the investor interest, in the management's interest in this railroad surviving. I mean this is a group that has put $1.2 billion on the table. If this road does not function, is not successful, and that goes down, they are the losers for that. And I think it is absolutely critical to understand that this group will act to protect its investment.

Will it covenant to put in extra money? It has not done that, and neither has Norfolk Southern. Sure, they are in the railroad business, and we have been complimentary over the years of Norfolk Southern as the operator of a railroad. We would be no more complimentary of Norfolk Southern's ability to operate a railroad than we are of Conrail's ability to operate a railroad.

Mr. RUNDY. I would like to add to that, Senator, just a couple of quick points. I know you have been talking to the people from Norfolk Southern, but they are the employees of Norfolk Southern. The shareholders are the people who own it.

If you look at Norfolk Southern's capital investment record recently, it has been in southeast banking, in Piedmont Airlines. I think also that you would want to think about asking whether or not the Norfolk Southern charter has any provision that would prevent a whole new management from coming in the day after Conrail was bought by Norfolk Southern because there is no 10-percent ownership limit in the next 5 years in the Norfolk Southern stock, the way that we are suggesting for Conrail, so that this committee could be talking about Norfolk Southern next year just the way you are about TWA.

You may think that is a little far-fetched, but if you look at just a couple of simple numbers, that after Norfolk Southern buys Conrail, more than half of its market value will be in cash. And if you looked at the fact that a number of aggressive investors have recently looked at the railroad industry, including Odyssey Partners

and the Bass Bros. it's not so far-fetched that this committee could be focusing on that, except that there is no safeguard.

So that irrespective of what the employees of Norfolk Southern may say, I think you have to think about who are the people who own Norfolk Southern today and who is going to own it next year.

The CHAIRMAN. Senator Exon.

Senator EXON. Gentlemen, I am impressed with your presentation. Let me go back to the first part, the questions that the Chairman asked. There was a statement made I believe by Mr. Riley that your projections of a 7-percent return were considerably above what other railroads traditionally make.

What is your answer to that weakness, that alleged weakness pointed out by Mr. Riley?

Mr. SAUNDERS. Senator, there are two responses to that. First, we talked about these dividends and that they are paid out in the area of 8 percent, 8½ percent. And it is absolutely correct to say that that is a high yield relative to other railroad stocks.

Recognize that what we are really talking about here is the payout ratio first. We are suggesting that we pay out 40 percent of Conrail's earnings in dividends. The average of the railroad industry payouts is 40 percent, and we are captive 40 percent. We cannot pay more than a 40-percent payout.

Norfolk Southern pays now 44-percent payout.

Senator EXON. And they are still a profitable railroad with adequate cash flow?

Mr. SAUNDERS. Absolutely.

Now, the point I would like to make, we are structuring this transaction to return it to the public. And Conrail—this stock is going to trade up in value. Now, one should sit here and think that this company is worth in a freely traded market, without the impact of a large public offering, without the sale of 25 million shares, and once the distribution is complete and the market risk is out of the way, Conrail is not worth $48 a share. This company is worth considerably more.

Now, when that stock appreciates and it gets to $60 a share, $55 a share, $65, whatever it goes to, the same dividend is going to be paid, the same $120 million. And guess where the yield will be at that point—right in line with other railroads.

Remember, we are not paying this yield to the investors so they can skim the cash out and leave town. They are standing by. They are taking the entire market risk. We are going to turn around and sell it to the public. What it will eventually do, it will appreciate to the level that it should have in a public market and its yield will come in line.

So to come at that yield as if it is an overpayment, it is a way to take dividends, exorbitant dividends out of the company, fails to recognize that we are as a group structuring a deal to put it back into the private sector and to the general public, ESOP-type holders, labor and others. And the yield is then going to be at 7 percent; it is not going to be 8.4 percent.

And when it achieves that market level commensurate with its value relative to Norfolk Southern and relative to other roads, that dividend question is going to be gone. But you cannot offer to sell it to the public with an unattractive dividend level on it.

That is part of your ability to structure it and put it back into the marketplace.

Mr. PETERY. If I might just add something to that, certainly we had to make this attractive versus Norfolk Southern, versus CSX and other railroads, in terms of price earnings and in yield. In our work, viability was very important. We are the buyers, we are taking the risk, and while we are doing this work, it was particularly difficult to deal with the fact that the seller, the Government, the investment bankers, were talking this property down.

So the question of viability has to be dealt with here when you assign PE ratios or establish values or talk about yield. The fact is, this is a turnaround situation with the least seasoned record. They don't have other corporate wealth outside the railroad area or a substantial coal base, and we had to create a relative good value to the investors that were taking risk.

Mr. RUNDY. The only thing I would add to that, Senator, is the 40-percent payout ratio was what the DOT covenant suggested. That is where the 40 percent came from.

Senator EXON. Would the answer be the same to the projections that were made by Mr. Riley and his group, that by 1989 you would have dwindled down the capital to about $300 million, which is a couple million below what they allege would be necessary to keep the railroad operating on a cash basis, because you are overpaying on dividends.

I assume that the answer that you just gave would also respond to this projection, is that right—that you have appreciation of stock, so this would not happen?

Mr. SAUNDERS. Well, that is correct. We don't have to pay out any more dividends, but we have run the numbers. We have run them at the following capital expenditures: $559 million for 1985; $609 million for 1986; $631 million for 1987; $651 million for 1988; and $638 million for 1989.

That is considerably more than Norfolk Southern spends. It is a bigger railroad. They spent less in capital expenditures than these levels. These are within a whisper, and meet the covenant. At the end of that period we still are over $500 million in cash. Stanley Crane has testified that it would require $250 to $300 million in cash to run this railroad.

We meet those covenants. Sure, someone can concoct some numbers and run cash down if they want to. I mean we can run any set of assumptions, but I do not understand why someone thinks that we would want to buy a railroad that is not viable.

Senator EXON. That has not been the reason for your general success in the past, has it?

Mr. SAUNDERS. Well, I hope that continues in the future, Senator. Thank you.

Senator EXON. My time is up. Thank you, gentlemen. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Long.

Senator LONG. Before you took the stand, Mr. Riley indicated that he didn't think Conrail could stand alone. He said he was told by someone in CSX, apparently on the authority of the chief executive officer, I assume, that they thought that Conrail could not

stand alone. He also said that Conrail alone would have to start out with a 5-percent rate increase.

Now, what is your comment on all that?

Mr. PETERY. Well, viability has become my task, and I found myself very pleased with events of 1985, because we feel that an acid test of any management in a cyclical industry like this railroad industry comes in a recession, and we have some kind of a recession now, and I think you all know what the reasons are.

And we find that this company, if measured in Norfolk Southern's ways of measuring itself, has done better in the downturn than the other two, and so Conrail, while we are forecasting and worrying about the 1987 recession and the 1992 recession right now, is producing a record of viability. Let me just explain what I mean.

Conrail's tonnage, for whatever the reason, declined 9.5 percent in the first quarter of 1985. Conrail's revenues declined 6 percent, and they managed by exceptional response, quick response and ability to control their costs—something which I would like to get into if I had more time in more detail—to achieve an 11 percent decline in operating income, which is far better than that of the Chessie and the C&O, B&O, in the same territory, same economy, a lot more coal, which was down 35 percent and almost as good as that of Norfolk Southern, which was down 10 percent.

So, one point is, Conrail is meeting our viability tests, because we have some kind of an unforeseen, unforecast recession right now, and second, we feel like this is the viable railroad in the east and the midwest because this is the low-cost producer of service.

There are three other railroads. Low-cost producer of service. Many ways that we can get it. We think we have the company that has the best routes, the best schedules, the highest market share, the lowest labor cost, the best cooperation from labor. They have an advantage.

We think in any deregulated environment which you all have created this will be the company that will do the best.

Senator LONG. Let me just get this straight in my mind. If your offer is accepted and Mr. Riley is right and whoever told him that the company could not stand alone is right, do I take it that that means that all these sophisticated investors you are speaking for here lose their money? Or is there some way they could get out of it and still take a profit out of that?

Mr. SAUNDERS. Well, I think that first I should be very clear and say I do not think he is right, and I do not think he could be further from wrong, and we would not be here with this group of investors if we felt there was a chance of that. Now, if he were right, and if there were a problem, then this investor group could stand to lose some money.

Now, let me go back and make one point. When an investor looks at an investment opportunity, he looks at two things. He looks at the up side, and he looks at the down side.

I think we are at the down side. This railroad is worth these shares in a freely traded market under any economic conditions that we have run through in our projections is worth, 85 percent of it is worth more than $1.2 billion.

And any seller of that that wanted to take the market risk if that is the business they were in and wanted to stand there and go through the distribution process and have to be there through those times and within that business and takes that risk can probably realize something better than 1.2.

So, the question from the investor's point of view in looking at this, where is the down side. Will it go below 1.2 billion, will it stabilize and hold at $48 a share in a free market? I think the evidence is very clear, and let me indicate that. The yields, as the chairman indicated, in the area of 8.4 percent when it starts off, the combined yields of Norfolk Southern and CSX, the two roads that are most comparable to this are 4.7 percent. There is a lot of down side between 8.4 and 4.7.

The multiple for 1986, the multiple for 1985 for CSX and Norfolk Southern is 8.1 times. This valuation has a multiple in the area of four to four and a half times. There is sufficient down side. This group of investors would not be here if they did not think there was a profit opportunity and if they did not think it was viable.

We are not here because someone asked us to show up in a process and pay a different price. We are here because the government wants to sell Conrail, and we believe it should. We do not think it is right to leave this company in limbo for a number of reasons, and the price was $1.2 billion, and it did not want to go through the process of distributing and taking the market risk, and we support that. We think that is appropriate. The Government is not in that business.

So, we have said we will put a group of investors in between the Government and the market, and we will take the risk, but there has to be a profit opportunity there for a group of investors to take that and assume that risk.

So every number, Senator Long, that we have pushed indicates this is doable, it is viable, and we will succeed.

Senator LONG. I would like to ask just one more question if I may, because that was a long answer, but it was completely responsive to the question. I just want to get it straight in my mind. Now, it was inferred by the previous testimony that CSX was in here as a spoiler to keep the deal from going through for Norfolk Southern. Now, if this is not a feasible deal, if it fails, if the Government takes your offer and the thing goes down the drain, is a flop, and turns out to be a bad mistake from an investment point of view, then all these people that are listed here as investors, including the rest of these 32 you mentioned, are already guilty of making a bad investment mistake, and you are guilty of advising them to make a bad investment, I would take it.

Mr. SAUNDERS. That is correct. That is absolutely correct.

Senator LONG. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Rockefeller.

Senator ROCKEFELLER. Mr. Saunders, just following up on Senator Long's question, if the deal goes bad, and Conrail does not work very well, I suppose you could argue that Norfolk Southern could lose some money, too, could they not, if their deal was consummated?

Mr. SAUNDERS. Well, again, I think Mr. Petery can speak to that, but they are in the same business, and they are in the same cycli-

cal business, and there is no reason to assume that they have an ability to escape from some of the same economic problems that this railroad would have.

Senator ROCKEFELLER. Right.

Mr. SAUNDERS. So they could be in exactly the same weakened condition at that time, and that is why there is the fallacy that this deep pocket commitment, which is really not there as a commitment, is always going to save Conrail. In fact, you come back, they may have equal or greater burdens.

Senator ROCKEFELLER. Getting to this question of dividends which has been approached from several directions, there is an assumption, I think, that somehow the dividends are guaranteed by definition. Let me ask you, will the dividends that are projected in your proposal in fact be guaranteed to the investors, or are they contingent as an ordinary matter upon performance of the company by decision of the board reviewing the performance?

Mr. SAUNDERS. Absolutely. There are no guarantees. These dividends would be determined in exactly the same way of any other public company, and the investors, if the dividends were cut, would have to stand the consequences of that particular cut. And I think you will find they are prepared to do that. They are regular investors in this.

Senator ROCKEFELLER. You have said here today that Norfolk Southern could in fact make investments to satisfy the capital investment covenant, and then use that equipment anywhere throughout their system should their deal go through. The point you make, I would presume, therefore is that Conrail could essentially be buying equipment for Norfolk Southern.

Now, is it not also possible that Conrail could be buying equipment, for example, maybe a locomotive from Norfolk Southern itself, and that that would be used throughout the system, and that therefore one could argue that Norfolk Southern should that happen would not be fulfilling the public purpose of the covenant whatsoever?

Mr. SAUNDERS. That is correct. It could happen. It does not say where they buy that capital equipment, and they would be in a position to do that. There is no question.

Senator ROCKEFELLER. One further question. We are not yet at the point of considering tax reform, but we are certainly talking about it, and there may or may not be some of it this year or next year, but in any event, should it happen, it is going to be significant in some way or another.

Is there something that might be either in the President's message with respect to tax reform or in Treasury One or Two or anything else that occurs to you that might discourage investors that you have attracted to this proposal?

Mr. CHAPOTON. Well, the major items you would reduce the tax benefits for the capital intensive industries by reducing the depreciation deduction and by repealing the investment tax credit on new capital expenditures; the basic offset is a drop in the corporate rate from 46 percent to 33 percent.

We have not run those numbers, but I suspect they would be less favorable to Conrail marginally than under current law.

Mr. SAUNDERS. Senator, I would make one other comment. The market is normally a pretty good student of those changes and the implications of those. The multiples and the prices in the railroad industry, and they would be affected the same way as any other railroad, do not reflect a concern that the present tax proposals being considered would have a significant impact on this business.

And in looking through—I mean, we have 25—we have $27 billion in market value invested in railroads right now. It is a well understood industry. It has one of the most competent analyst groups following it. That is another situation that people have not focused on.

This is not like—we are selling a business that is not understood by sophisticated investors. If you went down this investor group, they are heavy investors in railroads. They have their own analysts. They follow them. As I say, there are $8 billion in the eastern roads alone in capitalization.

For someone to suspect that we are not capable of getting $2 billion, $1.5 billion to $2 billion of additional equity money out of the marketplace for Conrail just fails to understand that we have a tremendous investment in this country in railroads and a tremendous following, and the market has never been stronger on railroads than it is now.

Senator ROCKEFELLER. With that in mind, Mr. Saunders, one of the points that Mr. Riley made with respect to capital expenditure covenants was that whereas it was true that the $350 to $500 million applied to both scenarios, the $500 million capital expenditure was the absolute flat-out maximum which your group would be able to come through with.

You have indicated in your testimony that this is not the case, that you could push upwards from that?

Mr. SAUNDERS. Well, we ran the numbers on Conrail management's new projections of capital expenditures, which are very high, and we effectively meet those. In looking at our numbers here, I would say the average coming across here is in the area of $630 million, which is up $100 million from last year's projections, so we have a lot of wherewithal to meet those capital expenditures.

Mr. PETERY. If I might just add something to that, Senator, that is with a property which starts out with the greatest level of investment spending with taxpayers' money which has been predicated on a railroad which was 25 percent larger in terms of tonnage, that has built in 30 years of rail life at steady state.

I have just been out there the other day, and they have 23 percent of their locomotives stored in good condition. These are very ambitious capital spending plans which presumably are responsive to accusations or to build future better property conditions into the system such as those bridge clearance lowerings to accommodate the double-stack container technology, et cetera.

They are building up the plant, still have growing cash, in fact, excess cash.

Senator ROCKEFELLER. And you have added that point, that there are more investors than when this was presented, and that there are evidently more people who are being attracted to your proposal each week?

Mr. SAUNDERS. Yes; we expect that we will have a number of additional investors within the next 2 weeks, and the order of magnitude of the requirements coming in are in the $75, $100 million range. I mean, there is no shortage of investors at this point. There was at one time prior to the chairman's challenge.

Senator ROCKEFELLER. Thank you, Mr. Chairman.

The CHAIRMAN. Next we have Senator Pressler.

Senator PRESSLER. First of all, let me compliment you on coming up with a very attractive alternative. I know you are just trying to present this, and I think you have done a good job.

I know it is not normally your role to get involved in a hearing such as this, but I think you are doing an excellent job. Let me ask questions in two areas I think that have not been covered. Many of the areas I am curious about have been covered.

One thing that we could clarify is, what assurances do we have that CSX will not participate in the management of Conrail? Would you support an amendment absolutely prohibiting any activity by CSX in terms of management?

Mr. SAUNDERS. The short answer is yes, we would support that, and so would they. They understand the role that they must be in, and they have been a good partner in that sense. We think they are in fact right now about as isolated as you can have an investor and have no right to participate on any committee, or in any way at all influence that committee.

But if we have to sterilize them further, I suspect that they would do that. Now, the ultimate sterilization is that they may not be an investor, and we may have the capacity as this goes forward to ask CSX to not be involved. I do not think that is right in some respects as it relates to how they have participated as a good partner, but that is doable. It is possible.

Senator PRESSLER. I do not think it is required either, myself. I am just throwing out the question. But I note they have 7.1 percent of the Conrail stock. Now, on the list of information on investors, I have read that and I know that Columbia University, Dartmouth College, Harvard Management Co.—is that the group that represents Harvard University? Or not necessarily?

Mr. SAUNDERS. Yes, that is correct. That is Harvard University.

Senator PRESSLER. And Princeton University, and maybe there are some other colleges in here. It appears to me they have about 8-percent total. Is that right? What are their usual investment practices, universities such as those? How do get their advice, or how do they come about being involved, or how do they hear about it?

Mr. SAUNDERS. Well, let me say first you will have the opportunity. Princeton will be represented here today, and Mr. Beck can respond to that directly. The way they heard about this was from us. We approached them and made the presentations, provided information, provided a very thick analysis of this, and in fact they then conducted their own studies and investigation of this investment opportunity.

Senator PRESSLER. For example, just picking someone at random here, who are the Harbert International, Inc.? They are 7.1. Or the Fisher Brothers Financial Development Co., for example? They are regular clients of yours, are they?

Mr. SAUNDERS. Yes, they are.

Senator PRESSLER. Who are they, then? What do they do? I guess it tells briefly over here.

Mr. SAUNDERS. Well, in the case of the descriptions we have placed in this, the Harbert is a company located in Birmingham, and John Harbert, who is on the National Coal Board, is the principal in that company, has been a very successful businessman, and in fact has been in the transportation business for years. He is as knowledgeable probably on this type business, investment, as anyone you will find on the list, personal involvement. He himself participated and made this decision.

The other, named Fisher Brothers, of course, are a real estate development company in New York, again, a very large investor in the equity markets and a customer of Morgan Stanley, in fact a customer of Goldman and all the other firms that you would have in here.

Senator PRESSLER. Well, I think the point is that these are all sophisticated investors, and I do not think it would be necessary to have an amendment prohibiting any activity by CSX. They do not intend to whereas, that is the opposite of Norfolk Southern. I just wanted to make that point.

Let us focus on the dividend issue for just 1 minute. It seems to me that the chairman made a very good point about the high rate of return for Morgan Stanley investors. Could you address this point in a bit more detail, and could you clarify for me whether you could pay these high dividends if you did not maintain a cash balance of above $500 million?

Mr. SAUNDERS. May I answer the first one by very clearly saying if we could not meet the cash covenant, and I again make the point we are the only one of these two choices that actually has to meet the cash covenant, we would not pay a dividend that would put us in violation of that convenant, and the investors would suffer the consequences of that as they do with respect to any other investment they have where the dividend could be changed and lowered.

It has a high yield. I come back just to emphasize again that yield is 8.4 percent, because it is being structured in order that it can be sold to the general public, and when it is done at that level the yield on that same $120 million in dividends is going to be substantially lower on a percentage basis because those shares will be sold at a somewhat higher price.

Senator PRESSLER. Mr. Chairman, my bell has rung. I ask unanimous consent to ask some additional questions for the record.

The CHAIRMAN. Fine. There may be from a variety of Senators of various witnesses.

Senator Ford.

Senator FORD. Thank you, Mr. Chairman. I want to get into two areas. One I am not very familiar with. The other one I will try. Let us talk about employees just a minute as it relates to employee protection.

What are the provisions that you have relating to employee protection—that is, say if you are successful and you do take Conrail over, what is the employee protection in your proposal versus the Norfolk Southern, or is there any difference?

Mr. SAUNDERS. First, the employee protection arrangements with labor have not been completely negotiated either by Norfolk Southern and ourselves. That is a discussion and an ongoing negotiation between management and labor. That has not been resolved, and we have not entered into an agreement as of this time with labor.

I think you will find first that the labor protection arrangements for an independent Conrail by definition can be very different than the labor protection arrangements involving the loss of jobs in an acquisition, but I think that the final judge as to the appropriateness of those labor protection arrangements will be the RLEA itself, and we are in discussions, but they have not been completed.

Senator FORD. What happens if the 15 percent of the stock held by the employees is offered in toto? Are you able or in a position to take all of it?

Mr. SAUNDERS. Under the present proposal, which suggests that the excess cash that Conrail has be used to acquire that stock, we would not be in a position to purchase all of the 4.4. In the first instance, only 1.6 million can be distributed. That is about $65 or $70 million. So if they tendered that, we could purchase it.

Senator FORD. There is a limit on the amount of that stock that can be tendered at any one time?

Mr. SAUNDERS. Yes; and it is a limit being established by the prudence of how much cash that you would use.

Senator FORD. So what we are doing here is dispelling the argument that you could not purchase the 15 percent. What you are saying here is that there is a cap and only a certain amount of it could be offered at any one time, and you can adjust to that?

Mr. SAUNDERS. That is correct.

There is another way perhaps to approach that and we would discuss that with labor, and that is, to the extent that this group of investors, we had overdemand, they could purchase those shares for the same $48 a share. So in effect, if you had an oversubscription there is a way to offer labor the ultimate flexibility to have either shares, keep it outstanding, or cash.

Recognize, one reason we think they may want to keep the shares is if we are right and they go up in value, then the package we have offered labor is not a $210 million ESOP, it is an ESOP that may be worth $300 million. So that could be very attractive, and they may well choose to hold the shares.

But if they want to sell, we can make arrangements, either from the company or perhaps from the investors, to buy shares at $48 a share. Now, that last wrinkle we have not negotiated with them or approached, but we could do it to the extent you have overdemand.

Senator FORD. From your figures, how many Conrail employees do you think will be relieved of their responsibilities if you should acquire the line?

Mr. SAUNDERS. There will be absolutely no loss of jobs associated with this investors group acquisition of Conrail, none. Now, if in the normal course of business Conrail has some job losses, like any other railroad, then that will occur. But incremental losses associated with it, not a job.

There is no reason to think there is a single employee that will lose his job as a result of this. We do nothing, remember, other than buy the Government's interest. We are just shareholders. We

have not done a thing but trade places with the Government on who owns 25 million shares of Conrail.

Same management, public board that will be put before this committee and the Congress prior to you having to act. That is, a public board that can come under full scrutiny. So there is no change. All there is is there has been an ownership change in someone's position in the stock, and the Government has sold it to a different group of investors. Nothing else has changed.

Senator FORD. Now, let me, before we go on, ask a couple more questions. What do you have to do that is different than if Norfolk Southern acquires the railroad as relates to filing on securities? You know, I am lost. I am a lost ball in high weeds out there. What do you have to do with filings and registering anything, if you have to register, or just what different?

You know, if you acquire the railroad what would you have to do representing stockholders versus the sale to Norfolk Southern? You know, I would like to get into that issue.

Mr. SAUNDERS. Well, first we would require and request that we have an effective registration statement as a condition of the closing. In other words, we want this group of investors to be in a position to meet its obligation to the Government, and that is sell it to the general public as soon as public.

Senator FORD. And you have not filed that yet?

Mr. SAUNDERS. No, we have not. And we would have to file, the company would have to prepare and file a registration statement, off of which we could offer these shares to the public, the full disclosure, normal due diligence, that would be conducted with a public offering.

Senator FORD. You are timely with that? You are not behind with that? You would not do that until later?

Mr. SAUNDERS. No; if you told us we could sell it next week, believe me, we would find a way to get there.

Senator FORD. What I am trying to find out is what would you do, you know, that would be different as it relates to the public? You would have to file with Securities and Exchange, or what all would you have to do? That is what I am trying to find out.

What is the difference in liability with the public offering than with the sale to Norfolk Southern by the Government?

Mr. SAUNDERS. There really is no difference, I think, in terms of the Government's position. The only real difference is——

Senator FORD. What is the difference in your position and Norfolk Southern's position?

Mr. SAUNDERS. We have to have a registration statement so we can inform and sell it to the public off of a registration statement.

Senator FORD. And Norfolk Southern does not have to have that?

Mr. SAUNDERS. They do not, because they are acquiring 100 percent and there is no distribution to the public. They require no document of that nature.

Senator FORD. Well, you have to file these papers. They are on record. This is somewhat different than what Norfolk Southern has to do. Do you have to go into more detail with your purchase?

Mr. SAUNDERS. That is correct, we would have to make a full disclosure with respect to all of these projections and everything else to the public.

Mr. RUNDY. Also, Senator, on an ongoing basis you and everybody else would know everything there is to know about Conrail, because Conrail every quarter would be required, ongoing, to continue to file, so that everyone would know what Conrail is doing, how is it doing, is it making money, is it losing money, what is happening.

That would not be the case with the Norfolk Southern. It would disappear.

Senator FORD. I am not sure I want to invest my dollar and a half because I am not sure I can understand all of it. But I am beginning to learn.

Mr. SAUNDERS. We would like to have you very much as an investor.

Senator FORD. I do not believe a dollar and a half would help you much.

Mr. SAUNDERS. It may.

Senator FORD. Mr. Chairman, let me throw something out here. I am very, very concerned about what we are hearing here today and what we heard previously and what we passed. And I think that the reputation of everyone here has been made clear—even you have come forward with saying that there is no question about the reputation.

We have to make the decision now whether we want to go with the Morgan Stanley, which would have to be done on the floor and not in the committee, unless we ask for the bill back to reconsider it based on the hearings that we have had here today or the hearings we might have in the future. Am I giving the parliamentary procedure properly?

The CHAIRMAN. Yes; I think, let me if I can ask a question to Mr. Saunders just exactly on this point. I think that we have to get on with it. I think that delay serves nobody's interest. We have talked about this before: Why the rush?

But as I understand the situation, we have an offer from Norfolk Southern that expires at the end of this year. We have an offer from Morgan Stanley that expires at the end of this year. We have, what is it, 70 legislative days?

Senator FORD. 55.

The CHAIRMAN. We have a tax bill which probably will be coming to the floor of the Senate, that will take several weeks. I am concerned that we are going to run out of time. It seems to me that maintaining the status quo really helps nobody, and that what we have to do is to set up a situation so that we can decide between the Norfolk Southern offer, the Morgan Stanley offer, or nothing.

We do not have to pass any bill at all. But just doing nothing, and just sitting around week after week having hearings is stupid. So I think what we should do is to try to see if we can shop a time agreement.

Senator FORD. Well, Mr. Chairman, you are getting a reputation around the halls for being Old Ironbucket. I think you have done a very good job of sitting here week after week listening to this, and we have become better informed. And I compliment you on your patience and your stability.

The CHAIRMAN. Well, I just appreciate that so much, I hardly know what to say.

Senator FORD. Well, don't. It is all right.

The CHAIRMAN. Well, here is what I think we should do. I think we should try to get the leader to bring this up on the floor of the Senate. And if somebody wants to offer an amendment which embodies the Morgan Stanley arrangement—and I am sure Senator Pressler or somebody will—then let us vote on it, and then let us vote on final passage.

Senator PRESSLER. Mr. Chairman, could I? In the interest of due speed, after the hearing would the chairman commit himself to an effort to get a very clean vote on the Morgan Stanley proposal, as opposed to others, so that there is no dilution, but a clean up or down vote on that? We are preparing legislation.

The CHAIRMAN. I would be happy to do that. I think, you know, if that can be worked out, you could offer a substitute. I would be delighted.

I think that what we should be doing is to make basically a decision as to which of the two approaches we want. Do you agree with that, Mr. Saunders? I mean, let us just get on with it, and if you win, fine, and if Norfolk Southern wins, fine. And then, do you think one of the two proposals should be enacted by Congress?

Mr. SAUNDERS. Yes; I think we feel very strongly that a stalemate and leave Conrail in limbo affects their ability to hire good management, affects their ability to keep good management. I mean, we run the risk in doing nothing of affecting this railroad.

This railroad is really one of the finest railroads in the country. The record demonstrates that. If someone goes out and rides the rails, it is an impressive plant. The more you tinker with it and leave management and leave the operation in limbo, you really ruin its viability. It needs to move on.

The CHAIRMAN. And time is of the essence, correct? And basically, would you further agree with me that the basic issue should be a pretty clean one?

I mean, if this could go to the floor of the Senate on a time agreement, and we could have someone offer an amendment on your proposal and have it debated and voted on, and then go to final passage without a lot of fussing around.

I think it is a matter of trying to decide between two basic propositions.

Mr. SAUNDERS. I would only say, I would only think you should slow it down if you were going to come out with the wrong decision as it related to us.

The CHAIRMAN. Would not either of the two choices be better than just leaving the status quo?

Mr. SAUNDERS. Well, I think it should not be left status quo. I would only suggest one thing, and that is not to get back to pushing that rock up a very steep hill. I do think this is a complicated matter. This proposal has just gotten on the table. There have been a lot of questions raised as to viability.

The only thing I would suggest at all with respect to your suggestion is there be enough time, and we would turn ourselves inside-out to be responsive, to answer questions, to look at any aspect of this proposal that leaves anyone uncomfortable. So the only thing I would urge is give people an opportunity to study this proposal in the depth that they need to make a fair judgment.

The CHAIRMAN. I promise you we will. I think it is a serious proposal and it deserves serious consideration, and we will. And we appreciate your willingness to respond to any followup questions on it.

But I do think that giving it the time to study is one thing, but just to procrastinate and put it off and delay it and never get it to the floor of the Senate is another thing. We should do it this year.

Mr. SAUNDERS. Well, we are ready and prepared to meet with anyone at any time, and we are in a position to give this information. And there is nothing that would slow us up in going forward very fast from our perspective.

And I can also tell you, our investors would like that. They would also like certainty and let us get on with it.

The CHAIRMAN. Right.

First Senator Pressler, then Senator Exon.

Senator PRESSLER. Mr. Chairman, there is an implication in your question that somebody has been procrastinating.

The CHAIRMAN. I put no such import on that.

Senator PRESSLER. I have been trying for over a month to get the antitrust printouts that I illustrated today, and only today we first got a commitment to get them. They have been held up, and I have not been holding them up. I have produced them——

The CHAIRMAN. There was no such implication. I am just simply exhorting us all to move forward.

Senator PRESSLER. The point is, I think some new information has come out as a result of these hearings. And whether it is 2 weeks or 1 month or 2 months, I think it is good we have these discussions.

But for example, I would not want to vote until my colleagues saw the results of the antitrust study, which we hope we will get now. But there has been procrastination. There is sort of an implication that those who have an alternative to Norfolk Southern are procrastinating. We have not been procrastinating.

The CHAIRMAN. There is no such implication, and I would hope we would all agree, and I think you would agree, that by some time the latter part of this summer we should be in a position to bring this bill to the floor, and you and I could work together in trying to fashion a reasonable time agreement to deal with it.

Senator PRESSLER. I would hope so, if we can obtain the information we have asked for.

Mr. RUNDY. I think, Senator, when you ask for that information you should ask for the Justice Department or DOT to consider the fact that Norfolk Southern in the next couple of days is going to close the acquisition of North American Van Lines, which is an important trucking company. And I think you want to think about, when you are saying these traffic studies, which I think may be a couple of years old, in fact has the strategic balance shifted and what does that mean in terms of Norfolk's ability to compete with truck traffic, and how is that going to change traffic flows?

Because I think it is an in.portant strategic move. We were involved in it. Mr. Petery is an expert on it and he can tell you that it was not a whimsical acquisition. It was a very important strategic move, and I think it has important strategic implications for our railroads throughout the United States.

Senator PRESSLER. I think that is a good point. Also, I would hope that, in view of the chairman's generous offer of an up or down vote, that the Department of Transportation would prepare a statement that they are ready to go with that if that is what the Senate decides.

The CHAIRMAN. Senator Exon.

Senator EXON. Mr. Chairman, just a comment and one question, if I might, of the panel. This has been a tremendously interesting afternoon. I am sorry that all of our colleagues could not be here. I would hope that we could expedite, if we could, the transcript of these hearings, to make sure that all of us, especially our colleagues who were not here because they had other commitments today, have a chance to study this, because I think this is a tremendously important issue. And I agree with you, we better move along on it.

I also agree with my colleague from South Dakota that we have just got to get the information from the Justice Department on the antitrust divestitures. That is one of the reasons that you know myself and others tried to hold back the final vote of this committee.

Now, a question of the three panelists—four members of the panel: Have you or any of you had the opportunity to make your presentation in person to the Secretary of Transportation? If not, why not? And have you offered?

Mr. SAUNDERS. Well, we have not met personally with the Secretary. We are certainly prepared to do that and would welcome that opportunity.

Senator EXON. Have you offered to give the Secretary of Transportation a briefing?

Mr. SAUNDERS. We have sent the information in papers, and I think it is fair to say that the Secretary is aware that we would meet with her at any time.

Senator EXON. I would think it might be helpful, Mr. Chairman. I was going to make a suggestion that you might advise the Secretary that she has the right to do what she wants, but that I think this proposal is interesting enough that at least the Secretary—and it is an important enough matter—that the Secretary of Transportation should hear what we heard today from these panel members.

She may change her mind. She came over here, you know, gung-ho, sold 100 percent that she had made the right decision. I think she thinks she has made the right decision, and maybe she has. But I suspect that she has not had an opportunity to hear what we heard today.

I think it is in the interest of fairness, in the interest of the public, and the interest of the taxpayers, that at least she hear from you people first-hand what we learned today.

Mr. SAUNDERS. Well, Senator, if I may say one thing. This proposal was in fact not before her and did not exist at the time she made that recommendation.

Senator EXON. I am aware of that.

Mr. SAUNDERS. So I think it is fair to say that she had to make a different decision in light of the fact this was not available.

Senator PRESSLER. I think that is very important, if my colleague would yield, to those of us who are working for a speedy sale under certain conditions, that the Department of Transportation not only hear these people, but agree that it's an alternative that they are prepared to accept if the Congress so decides.

That would be very important. If we vote up or down on it, it would be hard if the DOT says they will not accept it. And I would look forward to my colleagues and the chairman to get an agreement with the DOT that if we do have an up or down vote that there would be——

The CHAIRMAN. I do not know how to get any agreement from the administration that they would agree to do something with a bill once we have passed it.

Senator PRESSLER. You mean we would vote up and down and if we voted for it——

The CHAIRMAN. I would hope that we could just get this to the floor of the Senate and have as clear an alternative as we can between the Norfolk Southern proposition and the Morgan Stanley proposition, and see who wins the vote on final passage and see what happens downtown.

Senator PRESSLER. My concern is, and I do not want to belabor this, is that someone will say if you are voting for Morgan Stanley you are voting to kill the deal because the administration will not accept it. I think in the spirit of fairness we should try to persuade the administration that they would accept one or the other, depending on what the Congress decided.

Maybe there is a representative of the Department of Transportation here that could respond.

The CHAIRMAN. I think DOT is here in the room and you are free to pursue it with them later. Gentlemen, thank you very much for your testimony.

[The statement follows:]

STATEMENT OF THOMAS A. SAUNDERS III, MANAGING DIRECTOR, MORGAN STANLEY & CO., INC.

SUMMARY OF MORGAN STANLEY PROPOSAL

On May 14, 1985 Morgan Stanley announced the organization of a group of investors formed to purchase the U.S. Government's 85% interest in Conrail, and return it to the private sector as a viable, independent enterprise through one or more public offerings. At that time the transaction had a value to the government of approximately $1.8 billion, including $1.2 billion in cash and an estimated $600 million [1] (present value) in additional tax revenues to the government when compared to the Norfolk Southern offer. In addition, the Morgan Stanley proposal permits the government to share in any appreciation of the price of Conrail's stock, through the issuance of purchase warrants for one million shares of Conrail common stock, which may be exercised over a 10-year period.

The Morgan Stanley proposal also contains public interest covenants which are the same or equivalent to those negotiated between the Department of Transportation (DOT) and Norfolk Southern, including provisions relating to cash balances, dividends and capital expenditures. Under the Morgan Stanley proposal, Conrail will agree to surrender cumulative net operating loss and investment tax credit car-

[1] Morgan Stanley received on June 7, 1985, a revised Five-Year Outlook for Conrail with new projections for 1985-1989; the new forecasts call for higher earnings at Conrail which are expected to reduce the amounts of estimated revenue losses resulting from the transaction. Morgan Stanley has not yet been able to complete its tax analysis, which it expects to do in the next few weeks.

ryforwards and to return Conrail's "excess cash" to the government, in exactly the same way as the Norfolk Southern offer.

Over a period of time, not to exceed five years following the purchase, the investor group plans to resell to the public a majority of its interest in Conrail through one or more public stock offerings. The government will bear no market risk associated with future sales of Conrail stock. At the conclusion of such offerings, the investor group will own no more than 40% of an independent, financially secure Conrail, with no single investor owning more than 10%. For a five-year period no person will be permitted to acquire or increase its ownership to more than 10% of Conrail common stock, thereby assuring Conrail's future independence.

The Morgan Stanley proposal offers a number of important advantages over the competing offer to purchase Conrail by Norfolk Southern.

Better financial return to the government. The Morgan Stanley proposal exceeds the Norfolk Southern offer by approximately $600 million [1] (present value) because of the retention by the government of tax revenues that would be lost to the federal government under the Norfolk Southern offer. In addition, the stock purchase warrants offer the government an opportunity to participate in any appreciation of Conrail's stock price from the $48 purchase price—*at no risk and at no cost to the government.* Lastly, to the extent the investors realize gains, the group will pay taxes to the government, which will increase the government's return (permitting the government to participate further in any appreciation of the price of Conrail stock).

Preservation of rail competition. An independent Conrail will preserve effective rail freight competition in the northeast and midwest and connecting routes in the south and west. By substantially reducing or eliminating such competition on the major east-west corridors and on connecting routes, a Norfolk Southern-Conrail combination will lead to significantly higher costs to shippers and, ultimately, to increased prices to consumers. Preserving Conrail's independence will also avoid the need for untried and complex divestiture arrangments with small regional railroads which cannot guarantee effective competition to a dominant Norfolk Southern-Conrail combination. And it will preserve the delicate competitive balance that exists today in the nation's transportation system; a Norfolk Southern-Conrail combination could lead to a series of disruptive realignments in the transportation industry.

Better treatment for Conrail employees. The Morgan Stanley proposal recognizes the significant sacrifices made by Conrail employees in returning the railroad to profitability. It offers a flexible and comprehensive financial package valued at approximately $440 million, reflecting added value to the ESOP as well as cash payments to employees. This compares to $375 million contained in the Norfolk Southern offer. The Morgan Stanley proposal offers:

Preservation of the Conrail ESOP with a valuation of its underlying shareholdings amounting to approximately $210 million. Should the Conrail stock be trading in the public market at a price in line with the other major railroads, the value of the 4.4 million shares held in the ESOP could be significantly above the $210 million valuation. In contrast, the Norfolk Southern offer would force out the ESOP shareholding in Conrail.

The choice for individual ESOP holders to hold all their shares or sell a portion of those shares distributed from the ESOP to Conrail based on the same $48 price received by the government.

$200 million in cash to agreement employees and approximately $30 million in cash to non-agreement employees. Employees would have the option of using these payments to share in Conrail's future by participating in the investor group and purchasing common stock at $48 per share.

Fair labor protection arrangements.

Agreement employees a voice in Conrail's future by providing for two labor representatives on the Conrail Board of Directors.

By preserving Conrail as an independent entity, the Morgan Stanley proposal would avoid the industry-wide job losses inevitably resulting from the Norfolk Southern combination. As Norfolk Southern moves to realize merger efficiencies through reduction of the combined labor forces, and the market power of the combined railroads begins adversely to affect competitors, employment at Conrail, Norfolk, CSX and other railroads will decline. An independent Conrail will maintain its current Philadelphia headquarters and the major shop facilities in Altoona, Pa.

The proposal reflects firm cash commitments from a diverse group of institutions and professional investors, including pension funds, universities, money managers, investment companies and corporations. The investors undertake *all the market risk*—precisely that risk that the DOT has indicated it does not want to take.

The commitments of the investor group represent the strongest testimony to the economic viability of Conrail and to its future as a major independent rail carrier.

The $1.2 billion offered by the investor group includes none of Conrail's cash, and the transaction will not add to Conrail's debt or involve the issuance of preferred stock. In fact, Conrail will be one of the strongest credits in the industry after the transaction and, in Morgan Stanley's view, its equipment debt will carry double-A ratings or better. Conrail will have access to all capital markets in just the same way as the other major railroads in the United States.

In summary, the Morgan Stanley proposal will provide the government and its taxpayers with a superior return for their investment in Conrail and, at the same time, preserve effective rail competition the northeast and midwest without creating any complex antitrust issues requiring legislative resolution. If accepted, the proposal will result in a financially strong and independent Conrail, thus ensuring long-term employment opportunities for Conrail workers. It also will provide more attractive financial terms for employees. The proposal will not force out the ownership interest of the approximately 90,000 current and former employees who are beneficiaries of the existing Conrail ESOP. Rather, they will be offered a flexible, voluntary and equitable plan to realize the value of their investment in Conrail.

The Morgan Stanley proposal will better meet the interests of taxpayers, Conrail current and former employees, shippers and consumers. It satisfies the financial and public interest factors identified by Secretary Dole in establishing a process for the sale of Conrail under the Northeast Rail Service Act of 1981. As such, it represents a logical outgrowth and culmination of that process.

INFORMATION ON INVESTORS AND LIST OF INVESTORS

Name	Current allocation	Percent of Conrail stock
American Family Mutual Insurance Co	$25,000,000	1.8
American International Group, Inc	35,000,000	2.5
Citicorp Capital Investors, Ltd	50,000,000	3.5
Columbia University	25,000,000	1.8
Compagnie de Banque et d'Investissements	25,000,000	1.8
CSX Corporation	100,000,000	7.1
Dartmouth College	5,000,000	0.3
Digital Equipment Corporation Pension Fund	10,000,000	0.7
Diversified Capital	50,000,000	3.5
The Dreyfus Corporation	25,000,000	1.8
Fayez Sarofim & Co	30,000,000	2.1
Fisher Brothers Financial & Development Co	30,000,000	2.1
The Cottlieb Corporation	20,000,000	1.4
Harbert International, Inc	100,000,000	7.1
Harvard Management Company, Inc	50,000,000	3.5
KR Capital Advisors, Inc	50,000,000	3.5
George S. Livanos	25,000,000	1.8
Wm. W. Lowry & Associates, Inc	65,000,000	4.6
The Metropolitan Museum of Art	5,000,000	0.3
Morgan Stanley & Co. Incorporated	50,000,000	3.5
Nomura Securities International, Inc	70,000,000	5.0
NYNEX Corporation	25,000,000	1.8
Commonwealth of Pennsylvania Public School Employees' Retirement System	25,000,000	1.8
T. Rowe Price Associates, Inc. (on behalf of State of Delaware Board of Pension Trustees)	25,000,000	1.8
Princeton University	20,000,000	1.4
Quantum Overseas N.V. (By Soros Fund Management Co., Inc.)	50,000,000	3.5
Rosewood Financial, Inc	10,000,000	.7
Spears, Benzak, Salomon & Farrell, Inc	25,000,000	1.8
Sun Life Group of America, Inc	100,000,000	7.1
The Taubman Investment Company	25,000,000	1.8
United States Steel and Carnegie Pension Fund, Inc	25,000,000	1.8
Ezra K. Zilkha	25,000,000	1.8
Total investor group	1,200,000,000	85.0
Beneficial holders of ESOP		15.0
Total		100.0

SUMMARY DESCRIPTION OF MEMBERS OF INVESTOR GROUP

American Family Mutual Insurance Company, Madison, Wisconsin

American Family Mutual Insurance Company, founded in 1927, is the 28th largest insurance company in the United States and the fourth largest mutual automobile insurer.

American International Group, Inc., New York, New York

American International Group, Inc., is a holding company which through its subsidiaries is primarily engaged in a broad range of insurance and insurance-related activities in the United States and abroad. AIG's activities are divided into three principal areas: general insurance, life insurance and agency operations.

Citicorp Capital Investors, Ltd., New York, New York

A wholly-owned subsidiary of Citicorp N.A., Citicorp Capital Investors makes equity and venture capital investments for the account of Citicorp.

Columbia University, New York, New York

Columbia University is one of the nation's leading educational institutions, with 18,000 undergraduate and graduate students. The university's endowment approaches $1 billion.

Compagnie de Banque et d'Investissements, Geneva, Switzerland

Compagnie de Banque et d'Investissments is a bank chartered under the laws of Switzerland, with headquarters in Geneva. The institution offers all traditional banking services, and specializes in asset management and investment banking on a global basis.

CSX Corporation, Richmond, Virginia

Formed through the merger of Chessie System and Seaboard Coast Line Industries, CSX is a diversified corporation with interests in natural resources, real estate development and transportation. (The Conrail stock owned by CSX will be placed in a voting trust.)

Dartmouth College, Hanover, New Hampshire

Dartmouth College is one of the nation's pre-eminent private educational institutions, with a diverse student body of 4,000 undergraduate and 1,000 graduate students. The college's endowment exceeds $400 million.

Digital Equipment Corporation Pension Fund, Weston, Massachusetts

Digital Equipment Corporation is the second largest manufacturer of data processing equipment in the United States. Its pension fund has total assets of approximately $500 million.

Diversified Capital, Chicago, Illinois

Diversified Capital is an investment partnership formed by the Pritzker family of Chicago, Illinois.

The Dreyfus Corporation, New York, New York

The Dreyfus Corporation is a financial services organization which manages and distributes sponsored mutual funds, and provides investment advice to institutional and individual accounts. The corporation manages a group of funds with total assets of $22 billion for over 1.3 million shareholders.

Fayez Sarofim & Co. Houston, Texas

Fayez Sarofim & Co. is an independent investment counselling firm founded in 1958. The firm's clients include corporate pension funds, private endowment funds and individuals. Assets under management total over $8 billion.

Fisher Brothers Financial & Development Co., New York, New York

Fisher Brothers Financial & Development Co. is a real estate development company based in New York City which initiates and directs the construction of apartment buildings, hotels and office buildings. The Fisher Brothers organization is led by Zachary and Larry Fisher.

The Gottlieb Corporation, Kansas City, Missouri

The Gottlieb Corporation is a real estate development and management firm founded in 1946 and is under the direction of Arvin Gottlieb. The company specializes in shopping center activities throughout the midwestern United States.

Harbert International Inc., Birmingham, Alabama

Harbert International Inc. is a holding company organized in 1977. Its subsidiaries are engaged in construction of power and industrial plants, pipelines, highways and commercial buildings; operation of a natural gas pipeline; wholesaling of construction equipment; and development of real estate property.

Harvard Management Company, Inc., Cambridge, Massachusetts

Harvard University is one of the country's most prominent educational institutions. The university endowment has total assets approaching $3 billion.

KR Capital Advisors, Inc., New York, New York

KR Capital is an independent counselling firm managing investment accounts for pension funds of large corporations and private investors.

George S. Livanos, Lausanne, Switzerland

George S. Livanos owns significant worldwide shipping operations. Mr. Livanos also has various other investments worldwide.

Wm. W. Lowry & Associates, Inc., Atlanta, Georgia

Wm. W. Lowry & Associates is a diversified financial consulting firm founded in 1973, which engages in financial consulting, investment management and pension consulting. The firm and its affiliated companies serve corporate clients with over $10 billion in pension assets.

The Metropolitan Museum of Art, New York, New York

The Metropolitan Museum of Art is one of the world's most renowned art museums. Founded in 1870, the museum has a substantial endowment generated through contributions from individuals, foundations and corporations.

Morgan Stanley & Co. Incorporated, New York, New York

Morgan Stanley, founded in 1935, is a privately owned investment banking firm which serves governments, major corporations and financial institutions in worldwide capital markets. The firm provides a full range of investment banking services.

Nomura Securities International, Inc., New York, New York

Nomura Securities International, Inc. is a wholly-owned subsidiary of the Nomura Securities Co., Ltd. and engages, throughout the United States, in a variety of activities as a broker, dealer, underwriter and investment adviser. Nomura's participation in the U.S. capital market began in 1927 when it opened an office in New York; it was the first Japanese securities house to be admitted to the New York Stock Exchange.

NYNEX Corporaiton, White Plains, New York

NYNEX Corporation is the Northeast regional holding company formed as the result of AT&T's divestiture of its Bell system operating subsidiaries. The company provides telecommunications services through its subsidiaries, New England Telephone and New York Telephone.

Commonwealth of Pennsylvania Public School Employees' Retirement System, Harrisburg, Pennsylvania

This pension fund is the fourteenth largest public pension fund in the U.S., representing all professional and non-professional public school employees in the State of Pennsylvania. The fund has over $8 billion in assets with 220,000 active contributing members and 50,000 retired beneficiaries.

T. Rowe Price Associates, Inc., Baltimore, Maryland

(On behalf of State of Delaware Board of Pension Trustees)

T. Rowe Price is an independent investment management firm which provides advisory services for pension, profit-sharing, and other employee benefit plans, endowments, foundations, trusts, individuals, corporations and investment companies. The firm has total assets under management of $17.7 billion.

Princeton University, Princeton, New Jersey

Princeton University is one of the nation's oldest and finest private coeducational institutions. It maintains as its primary focus the education of its 4,500 undergraduate students. Princeton's endowment has total assets of over $1 billion.

Quantum Overseas N.V., Netherlands Antilles

(By Soros Fund Management Co., Inc.)

Quantum Overseas is one of the investment accounts under the management of Soros Fund Management, an international investment advisor with funds managed for large private investors. Soros Fund Management Co. is located in New York and was founded and is under the direction of George Soros.

Rosewood Financial, Inc., Dallas, Texas

Rosewood Financial, Inc. is one of the related group of corporations owned by the Carolyn Hunt Trust Estate. The corporations constituting the group engage in a variety of activities including oil and gas exploration, real estate and hotel development, ranching and venture capital.

Spears, Benzak, Salomon & Farrell, Inc., New York, New York

Spears, Benzak, Salomon & Farrell, Inc. furnishes portfolio management to pension funds, non-profit institutions and individuals. The firm manages investment accounts with aggregate assets under management of approximately $1.1 billion. The commitment of Rockefeller & Co. Inc. and Spears, Benzak provided for the reallocation of their joint commitment. In consultation with Morgan Stanley it was mutually agreed that Spears, Benzak would assume the entire amount of the commitment.

Sun Life Group of America, Inc., Atlanta, Georgia

Sun Life Group of America, Inc. is a life insurance holding company which is a wholly-owned subsidiary of Kaufman and Broad, Inc., Los Angeles, California. The life insurance companies of Sun Life Group represent $1.5 billion of assets. In addition, Kaufman and Broad is engaged in residential home development, manufactured housing and mortgage banking.

The Taubman Investment Company, Bloomfield Hills, Michigan

The Taubman Investment Company is a private investment concern under the direction of A. Alfred Taubman, one of the nation's major developers of retail and commercial real estate projects. The Company's other investments include Sotheby's, fine arts auctioneers; Woodward and Lothrop, a department store chain; and A&W Restaurants.

United States Steel and Carnegie Pension Fund, Inc., New York, New York

The United States Steel and Carnegie Pension fund, Inc. is the fourth largest corporate pension fund in the United States with total assets of over $4.4 billion.

Ezra K. Zilkha, New York, New York

Ezra K. Zilkha is President of Zilkha & Sons, Inc., a private investment company. Mr. Zilkha is on the Board of Directors of several major corporations, including CIGNA, Revlon, and Newhall Land and Farming. He is also a Trustee of the Brookings Institution and the International Center for the Disabled, and is a Trustee Emeritus of Wesleyan University.

Investor Commitments. Each investor has signed a commitment letter substantially in the form of the letter presented on page 9. It is the industry practice to rely on letters of this type in connection with private placements of debt and equity securities.

It should be noted that the commitments of both the Morgan Stanley investor group and Norfolk Southern are contingent upon the negotiation and execution of definitive agreements with the Department of Transportation. Norfolk Southern, actually, has signed only a *nonbinding Memorandum of Intent ("MOI")* and is simply obligated to use best efforts to proceed toward negotiation of a Definitive Agreement. Once the Definitive Agreement is executed, Norfolk Southern has set certain conditions that must be met prior to closing. The other contingencies set forth in the investor group's commitment letters can be compared to the MOI, as follows:

Morgan Stanley Group	MOI
1. Passage and signature into law of appropriate legislation to authorize the transaction.	1. Such legislation is a condition to closing. (Paragraph 9(d), 10(d).)
2. A satisfactory arrangement with Conrail's Agreement Employees.	2. Such arrangement is a condition to closing. (Paragraph 2, 9(c).)
3. An effective registration statement	3. No comparable provision; no registration needed because no public sale of Conrail stock is contemplated.
4. Lack of any material adverse changes	4. A condition to closing. (Paragraph 10(f), 10(g).)

Morgan Stanley Group	MOI
5. Approval by our counsel	5. Effectively, a condition to closing since opinion of counsel for DOT must be "reasonably acceptable to Buyer". (Paragraph 10(h).)

LETTERHEAD OF INVESTOR

———— —, 1985.

MORGAN, STANLEY & CO., INC.,
1251 Avenue of the Americas,
New York, NY 10020

As Agent for the Investors referred to below

DEAR SIRS: By signature hereto, the undersigned commits to invest the amount indicated below toward the purchase of the 85% block of common stock of Consolidated Rail Corporation ("Conrail") currently held by the United States of America. This commitment is subject to the passage and signature into law of appropriate legislation to authorize the transaction, a satisfactory arrangement with Conrail's Agreement Employees, an effective registration statement, the negotiation of a definitive purchase agreement with the U.S. Department of Transportation exhibiting substantially the terms set forth in the Invitation to Investors dated April 18, 1985, lack of any material adverse changes, and approval by our counsel.

The commitment provided by this letter will not terminate until December 31, 1985.

Very truly yours,

Amount of Commitment:
$

(Name of Investor)
By:
(Title)

DESCRIPTION OF MORGAN STANLEY PROPOSAL

Background of Morgan Stanley Role. Morgan Stanley was retained in April 1984 to advise Conrail's Board of Directors on various issues relating to the proposed sale of the company. In June and July 1984 Morgan Stanley advised the Board concerning:

the reasonableness of financial forecasts prepared by Conrail management for 1984–1988;

Conrail's viability as a going concern;

Conrail's value under various assumed circumstances; and

the feasibility of a public offering of Conrail equity securities by a group of underwriters as a means of effecting transfer to Conrail to the private sector.

Morgan Stanley testified publicly on several occasions with respect to these issues. Morgan Stanley also responded to Conrail's requests to meet with labor and other parties of interest.

At the request of Conrail's Board in December 1984, Morgan Stanley assisted management in preparing a hypothetical privatization plan incorporating a public offering of Conrail equity securities, which was submitted to Secretary Dole on January 4, 1985.

On January 18, 1985, Conrail's Board of Directors announced that Morgan Stanley had successfully completed its assignment for the Board of Directors and its engagement was terminated. Since January 18, 1985, Morgan Stanley has remained convinced that the public offering concept remained the best alternative for Conrail. To this end, Morgan Stanley announced on May 14, 1985 that it had organized an investor group and put forward the terms of the group's proposal.

The offer by the investor group provides the opportunity to evaluate the alternative of an independent, publicly held Conrail without burdening the government, as seller, with market risk and Conrail, as issuer, with debt and preferred stock in its capital structure. It offers an alternative that avoids the public policy problems of unemployment, reduced competition and tax losses that are associated with the Norfolk Southern proposal.

Terms of Morgan Stanley Proposal. The Morgan Stanley investor group propses to purchase for cash the 25 million shares of Conrail (85%) owned by the U.S. Government for $48 a share or a total of $1.2 billion. In addition, the Morgan Stanley group will cause Conrail to issue to the government 10-year warrants to purchase one mil-

lion shares of Conrail common stock at a price of $48 a share, the same per share price at which the investor group is buying Conrail. The warrants will be exercisable at any time starting 90 days after the first public offering up to 10 years after the closing. The warrants represent approximately 3.5% of the amount of Conrail's currently outstanding stock and permit the government, at no risk, to share in the appreciation of the price of Conrail stock.

The group will also commit to return to the government any Conrail "excess cash," defined in the same manner as in the Norfolk Southern proposal. It will agree to surrender cumulative net operating loss and investment tax credit carryforwards, also consistent with the Norfolk Southern offer. Unlike Norfolk Southern, however, the investor group will not use Conrail tax deductions to shelter non-Conrail income.

Over a period not to exceed five years, the investor group will resell its shares to the public. The government will not bear any market risk associated with future sales of Conrail stock. Through such sales the group will reduce its aggregate ownership to no more than 40% of Conrail's outstanding shares and no single investor will hold more than 10%. For a five-year period from the closing date, no person will be permitted to acquire or increase its ownership to more than 10% of Conrail common stock. No member of the initial investor group will be able to sell shares outside the group without the consent of the group.

CSX Participation. CSX's holding in Conrail will be subject to the most stringent conditions. CSX has agreed that its shares will be held in a voting trust meeting ICC guidelines and in compliance with the proportionate voting requirements of Section 401(d) of the Regional Rail Reorganization Act of 1973. These restrictions will apply to CSX as long as it holds Conrail stock. In addition, CSX will not participate in management, will not have a representative on the Conrail Board and will not participate in the Executive or the Finance Committee of the investor group. Therefore, in no way will CSX have the ability to influence the management of an independent Conrail. It will have no advantage over Norfolk Southern or any other railroad that chooses to take a position in the stock of a publicly held Conrail.

In addition, under the Morgan Stanley proposal, participants in Conrail's Employee Stock Ownership Plan (ESOP) will have the option to retain their shares or sell a portion of those shares which would be distributable from the ESOP to Conrail for the same $48 per share price received by the government.

The Morgan Stanley proposal will result in an independent Conrail, which will be one of the strongest credits in the industry. Its capitalization will include no additional debt or preferred stock. *The investors will not use any Conrail cash to acquire the government's interest.*

Financial Return to the U.S. Government. The Morgan Stanley proposal provides financial returns to the U.S. Government that are superior to the value of the Norfolk Southern offer:

a $1.2 billion cash purchase price;

return of Conrail "excess cash" to the government;

approximately $600 million [2] (present value) in tax revenues that would be lost to the federal government under the Norfolk Southern offer;

warrants on one million shares of Conrail common stock exercisable at $48 per share at any time starting 90 days after the first public offering up to 10 years after the closing. This permits the government to share in any appreciation of the price of Conrail's stock; and

tax revenues arising out of taxes on gains of the investor group's sales of stock.

Set forth below is a comparison of the investment return of the two proposals:

COMPARATIVE INVESTMENT RETURNS

	Morgan Stanley	Norfolk Southern
Investor cash	$1.2 billion	$1.2 billion
Conrail "Excess Cash"	Reverts to government.	Same

[2] See footnote 1.

COMPARATIVE INVESTMENT RETURNS—Continued

	Morgan Stanley	Norfolk Southern
Sharing with Government	Government will receive warrants for one million Conrail shares and tax on investor gains.	None
Elimination of estimated revenue losses to Government (present value)	$600 million (1)	
Total value to Government	$1.8 billion plus value of warrants and tax on invest gains.	$1.2 billion

[1] See footnote 1 of statement.

The Morgan Stanley proposal provides superior cash proceeds to *all shareholders* of Conrail.

	Morgan Stanley	Norfolk Southern
Price per Share to U.S. Government [1]	$48.00	48.00
Present Value per Share of Revenue Losses to Government [2]		(24.40) [5]
Net Proceeds per Share to Government	$48.00	23.60
Price per Share for Employees through ESOP [3]	48.00	17.00
Average Price per Share [4]	48.00	2.61

[1] Excluding in both cases Conrail "excess cash".
[2] The value today of estimated revenue losses arising from the Norfolk Southern offer.
[3] Under the Morgan Stanly proposal ESOP participants will have the option to sell a portion of their shares to Conrail for $48 or hold shares that will be tradeable in the public market after the initial public offering. Under the Norfolk Southern proposal, the ESOP holdings of 4.4 million shares will be "forced out" for an amount originally said to be $75 million in cash or Norfolk Southern shares. To the extent the ESOP shares are valued at a higher amount, the per share value will increase.
[4] Assuming 29.4 million shares of Conrail stock.
[5] See footnote 1 of statement.

Arrangements with Conrail Employees. The investor group recognizes the important contribution employees of Conrail have made and will continue to make towards Conrail's profitability. Its proposal includes a comprehensive financial package for employees valued at approximately $440 million.

Conrail will offer participants in the ESOP the option to retain their current shareholdings or sell a portion of those shares that would be distributable from the ESOP to Conrail for the same $48 per share price received by the government. At a price of $48 a share, the Conrail shares held by the ESOP will have a value of $210 million.

Conrail will also offer $200 million in cash to its agreement employees and approximately $30 million in cash to non-agreement employees. Employees will have the option to use these payments to participate in Conrail's future by participating in the investor group and purchasing common stock at $48 per share.

In addition, the investor group proposal provides for the agreement employees to have two representatives on the Board of Directors of Conrail.

Moreover, through the collective bargaining process, Conrail and the RLEA will provide for job protection arrangements.

Public Interest Covenants and Other Aspects of the Proposal. Under the Stanley Morgan proposal, Conrail will abide by operating covenants that are the same or equivalent to those agreed to by Norfolk Southern with the Department of Transportation, includirg requirements related to cash balances, capital spending and dividend payments.

The covenants under which Conrail will operate were originally designed in contemplation of a private sale to a single corporate purchaser. Stanley Morgan has publicly stated its willingness to accept the covenants on essentially the same basis as Norfolk Southern. Clearly, the question of whether the covenants should apply to an independent, publicly-held Conrail is a legitimate one and deserves full and careful consideration by Congress. No other publicly-held railroad has such covenants.

The investor group proposes that Conrail's Board of Directors be reconstituted so that there will be 15 members: two from Conrail management, two representing labor and 11 from the general public. The Board, thus constituted, would be designed to be of the highest quality and capable of directing Conrail long after the investor group has ceased to exist as a group. The initial membership of the Board will be made known prior to Congressional resolution.

Lastly, the proposal herein contemplates that, at the closing of the transaction, the debentures, preferred stock, and contingent interest notes of Conrail held by the United States would be cancelled.

Comparison with the Norfolk Southern Proposal

Ownership and Control. Norfolk Southern will acquire 100% of Conrail and have total business and operating control.

The investor group will acquire 85% of Conrail, leaving ESOP beneficiaries with their 15%. Ultimately, no investor will hold over 10% during the five-year period. No investor will be able to exercise control over Conrail, because of the diversity of the investor group, the ownership restrictions, the ESOP holdings, the anticipated public offerings, and the independent Board with representatives from labor.

Use of Assets. Norfolk Southern will control property and equipment having a total value of $4.6 billion (12/31/84). Many of these assets can be used by Norfolk Southern in its own business, a benefit not available to the investor group, the ESOP holders or the public shareholders.

Use of Conrail's Cash. Since Norfolk Southern will control Conrail, it will own all of Conrail's cash balance of at least $800 million. There should be no doubt on anyone's part that this cash can be used by the entire Norfolk Southern group. Notwithstanding the Norfolk Southern assertion that it will use its own funds to settle wage claims and buy out the ESOP holders, Norfolk Southern can effectively recoup these funds from Conrail cash immediately following the closing.

In fact, if Norfolk Southern chooses not to sell Conrail pay dividends, Conrail will never have to meet the $500 million cash balance covenant. It could simply make intercorporate loans for the five-year period in which the public interest covenants are in effect.

By contrast, neither the investor group nor any member thereof will have access to Conrail's cash.

Tax Shelter. With Conrail as a wholly owned subsidiary, Norfolk Southern gains *significant tax benefits*—in particular, from Conrail's high depreciation deductions and excess investment tax credits.

Norfolk Southern will also be able to deduct currently from its taxes the amounts paid to employees of Conrail in settlement of prior wage claims and interest payments on the entire purchase price.

The investors in the Stanley Morgan group will in no way be able to use for their own benefit any tax deductions or investment tax credits not utilized by Conrail.

And the investor group will not receive tax-free dividends. Setting the earnings and profit account at $500 million will insure that Conrail dividends will be currently taxable as ordinary income.

Competitive Advantages. Norfolk Southern will gain tremendous competitive advantags through its acquisition of Conrail. Using its acquired monopoly power, including its exclusive access to numerous cities, power plants, mines, mills and other industries, a combined Norfolk Southern-Conrail will reap enormous financial returns, which are extremely difficult to quantify. Under the investor group proposal, competition would be maintained among the major railroads.

Effects of Covenants. If Norfolk Southern elects to have Conrail pay no dividends, the dividend convenant and associated $500 million cash balance covenant are meaningless. On the other hand, a publicly held Conrail will have no choice but to pay its public shareholders quarterly dividends in line with industry practice. Thus an independent Conrail must actually meet the $500 million cash balance covenant.

Although Norfolk Southern has agreed to meet minimum cumulative capital spending at Conrail of $350 million per year, it has the ability to have Conrail acquire equipment (such as rolling stock or computer equipment) for use throughout the Norfolk Southern system. Not so with an independent Conrail, which will devote all its capital spending exclusively to the Conrail system.

Since the public interests covenants are fully operative for an independent Conrail, the investor group has requested two changes. The first is designed to deal with the earnings seasonality, especially for a transaction closing at year-end, and calls for an ability to pay the first two quarterly dividends with regard to the 40% of cumulative income test. The second recognizes the obvious impossibility of seeking dividend refunds from a broad group of public shareholders by proposing a require-

ment to discontinue dividends, and not refund dividends already paid, if and when cumulative capital spending levels of $350 million per annum are not met.

Conrail's Pension Fund. Norfolk Southern will obtain access to the excess cash in Conrail's pension fund. It will be able to merge the Conrail pension fund with its own plan, and may later terminate the combined plan. Since the Conrail pension plan is deemed to be overfunded on a termination basis by approximately $250 million, such a step would yield Norfolk Southern an important cash benefit—one that many companies have taken advantage of following acquisitions. The investor group is committed to maintaining Conrail's pension plan.

Indemnification and Exculpation. Norfolk Southern has asked for indemnification or other assurances running to certain matters relating to tax (especially a warranty of federal income tax results from the DOT) and an exculpation from fiduciary duties for the ESOP fiduciaries. No such indemnification has been requested by the investor group.

In conclusion, Norfolk Southern's investment in Conrail must be extraordinarily attractive to Norfolk Southern. After factoring in tax savings, usage of Conrail cash, and competitive gains, the true cost of Norfolk Southern's investment is without a doubt far below $1.2 billion. Moreover, many of the benefits that Norfolk Southern will obtain have been made possible largely by contributions of taxpayer funds, and the continued efforts of labor and management.

None of these particular benefits will be made available to the public shareholders or the investor group.

Future Commitment to Conrail. Is There a Hole in Norfolk Southern's Deep Pocket?

In no way has Norfolk Southern committed to put additional cash up in support of its investment in Conrail. There is *no covenant* to this effect. Norfolk Southern's own history of permitting the failure of its economically troubled Delaware and Hudson and Erie-Lackawanna in the early and mid-1970s stands in sharp contrast to any hopes that Congress may have for a "deep-pocket" commitment from Norfolk Southern for Conrail

Let it be clear: Norfolk Southern is prepared to invest in Conrail now only because its Board believes the returns to its public shareholders reflect the risk involved.

Investors in the Morgan Stanley group, ESOP shareholders and future public shareholders will be just as committed to the ongoing viability of Conrail as are the current public shareholders of Norfolk Southern. In fact, both the Morgan Stanley and Norfolk Southern proposals offer the same commitment to maintain Conrail as a going concern.

It is distorting to suggest, as does Norfolk Southern, that the Morgan Stanley proposal is a "blueprint for cannibalization" and dismemberment of Conrail. In truth, at the end of the five-year covenant period, it is Norfolk Southern that will be in a better position to dismantle Conrail under the Norfolk Southern proposal—not a public shareholder under the Morgan Stanley proposal. Why? Because Norfolk Southern will own 100% of Conrail and will control decisions of any disposition of Conrail. Under the Morgan Stanley proposal no public shareholder will own more than 10%, no shareholder seeking to take control of Conrail will have any advantage over another, and any shareholder seeking control will have to pay an acquisition premium and be subject to ICC and other regulatory review. Clearly, a future dismantling of Conrail under the public offering alternative will be exceedingly difficult and subject to full public scrutiny.

CONCLUSION

Background

The Northeast Rail Service Act of 1981 established that Conrail should be sold as a complete entity if it:

—met profitability tests;
—had sufficient revenues to meet expenses, maintenance and reinvestment; and
—had access to private capital markets.

Conrail is, today, profitable, viable and highly creditworthy.

The Department of Transportation goals in a sale of Conrail are:

—to preserve rail service in the northeast to the greatest extent possible;
—to leave the railroad in a strong financial position to prevent reversion to government ownership; and
—provide maximum return to taxpayers.

Morgan Stanley Proposal Best Meets All the Criteria for Sale

Results in a viable and competitive Conrail; returns Conrail to the private sector to be held by the public as an independent company.

Preserves effective rail freight competition in the northeast and midwest; retains delicate competitive balance that exists today in the nation's transportation system; avoids serious anti-competitive problems raised by the Norfolk Southern merger.

Yields a higher financial return to the government and permits participation in Conrail's future by a broader group of taxpayers.

Provides better treatment for Conrail employees who will be able to participate in Conrail's future as shareholders and through representation on the Board; avoids industry-wide job losses inevitably resulting from the Norfolk Southern merger.

Appendix A—Tax Considerations

In order to determine the true proceeds from the sale of Conrail, it is necessary to net out of stated proceeds of the sale any negative impact of the transaction on future tax revenues to the federal government, calculated in terms of present value, which recognizes the time value of money. This is particularly important in fully understanding the government's choice in this instance because Norfolk Southern will be able to utilize Conrail's tax benefits in its business in a manner unavailable to any member of the investor group. The different impact on future tax revenues of the Norfolk Southern and the Morgan Stanley group proposals is significant and can be quantified with analytical techniques commonly used by the financial community. Once the present value of the foregone tax revenues is calculated, it must be deducted from the stated gross proceeds to compare the net proceeds to be received under each proposal.

In a letter to Members of Congress, dated May 8, 1985, Norfolk Southern concedes that it "expects some short run reductions in Norfolk Southern's federal income tax payments as a result of the acquisition of Conrail." In his statement on June 6, 1985 before the House Subcommittee on Commerce, Transportation and Tourism, Chairman Claytor of Norfolk Southern conceded that his company would have reduced taxes (by an amount of less than $100 million) as a result of the Conrail acquisition. In questioning, however, Mr. Claytor mentioned that his company might consider walking away from the deal if Norfolk Southern's ability to use Conrail's tax deductions were restricted.

The Joint Committee on Taxation, in its report to the House Committee on Ways and Means, dated April 30, 1985, confirms there are ways for Norfolk Southern to use Conrail's tax attributes to shield Norfolk Southern taxable income. In order to quantify these reductions Chairman Rostenkowski of the Ways and Means Committee formally requested that such financial projections of Norfolk Southern be made available to the Committee. Preliminarily, the Joint Committee estimates revenue losses to the government of approximately $100 million per year. In a June 6, 1985 letter from the Director of the Congressional Budget Office (CBO), Rudolph G. Penner to Chairman Danforth, the CBO concurs that the lost tax revenues to the government over the period 1986–1990 would be $400 million, resulting from Norfolk Southern's ability to use Conrail's depreciation deductions and to deduct its proposed payment to labor in settlement of prior wage claims.

Considerable effort has been made to quantify the tax revenues that the government will forego as a result of a Norfolk Southern-Conrail combination. Financial projections were reviewed in consultation with Morgan Stanley's railroad analyst, Andras Petery, and reviewed by Emil Sunley, former Assistant Secretary of Tax Analysis and now at Deloitte, Haskins & Sells. These projections, together with information provided by the Railroad Retirement Board, were reviewed by the law firm of Piper & Marbury and by Sheldon Cohen, former IRS Commissioner and now at the law firm of Morgan Lewis & Bockius.

Conrail and Morgan Stanley have attempted to develop a reasonable estimate of the net present value of the tax revenues that would be foregone if the sale of Conrail to Norfolk Southern were to be consummated. Mr. John E. Chapoton, former Assistant Secretary of the Treasury for Tax Policy and currently a partner in the Washington office of Vinson & Elkins, was asked to review the methodology of these calculations, and the testimony prepared by Mr. Chapoton is included herein. Further analysis is dependent upon full disclosure by Norfolk Southern of its financial projections and its calculations based upon the new Conrail economic projections, as well as projections by all railroads of their expected job losses. Such data are crucial in developing an accurate financial comparison between the two proposals.

STATEMENT OF JOHN E. CHAPOTON

TAX CONSEQUENCES OF PROPOSED CONRAIL SALE

My name is John E. Chapoton, and I am a partner with the law firm of Vinson & Elkins. We are serving as tax counsel to Morgan Stanley & Co. Incorporated in the matter under consideration by this Committee.

I am pleased to have the opportunity to present our analysis of the impact on federal tax revenues from the competing offers to purchase the Consolidated Rail Corporation from the Department of Transportation. Since the seller of Conrail is the U. S. Government, it is, of course, necessary to consider any loss in tax revenues to the federal government from the competing proposals. The loss in tax revenues may be considered in absolute dollar amounts per year over the budget period 1986-1990, or it may be expressed in present value terms by discounting the future revenue losses to the date of the sale of Conrail. However the loss is expressed, it must be fully considered in evaluating the competing purchase offers.

In a June 6, 1985 letter to Chairman Danforth, the Director of the Congressional Budget Office, Rudolph G. Penner, analyzed the budget impact of the proposed sale of Conrail to Norfolk Southern. A part of that analysis discussed the estimated loss in tax revenues to the federal government through 1990 as a result of a sale of Conrail to Norfolk Southern. The Joint Committee on Taxation estimates on which the CBO tax analysis was based compared the lost tax revenues resulting from a sale of Conrail to Norfolk Southern with the situation if no sale occurred and Conrail continued to be owned by the federal government. In this testimony, we wish to explain why those factors which give rise to a loss in future tax revenues in a sale of Conrail to Norfolk Southern do not exist to the same extent in the case of a publicly held Conrail.

The CBO letter concludes that there would be a significant loss in future federal tax revenues if Norfolk Southern purchased Conrail. Both the Joint Committee on Taxation/CBO analysis and our previous analysis were of necessity based on Conrail's economic projections made last year. As the Committee is aware, last Friday Conrail released its new five-year economic projections. We are in the process of analyzing the impact of these new projections on the loss of tax revenues from the use of depreciation deductions, investment tax credits and wage settlement deductions by a Norfolk Southern-owned Conrail.

The tax revenue differential between a Norfolk Southern-owned Conrail and a publicly held Conrail has been computed with respect to two separate aspects of the transaction.

First, we concluded that a loss in future tax revenues would result from depreciation deductions and investment tax credits if Norfolk Southern acquired Conrail whereas there would be no such loss in a public sale of Conrail. Based upon the previous Conrail projections, we had estimated a loss from depreciation/ITC utilization of approximately $366 million in present value terms using a 10% discount rate. The new Conrail projections are expected to reduce that number.

Second, we determined that, by the year 2000, there would be a $1.8 billion cumulative net reduction in the Tier II account balance (or, expressed in present value terms using a 10% discount rate, a $245 million revenue loss) to the railroad retirement fund as a result of an estimated 10,000 jobs lost in railroad employment if Norfolk Southern acquires Conrail, which job loss would not occur if Conrail operates as a stand-alone entity.

In addition, it is possible that tax revenues would also be lost due to tax deductions derived from Norfolk Southern's proposed allocation of $375 million between amounts payable in settlement of wage claims by Conrail employees and amounts payable to beneficiaries of Conrail's Employee Stock Ownership Plan. Unless these deductions could be utilized by a stand-alone Conrail, there would be little, if any, loss in future tax revenues during these years from any similar payments made by an independent Conrail.

Utilization of Depreciation Deductions

The provisions of the Memorandum of Intent entered into by Norfolk Southern Corporation and the Department of Transportation guarantee a depreciable basis in Conrail's assets equal to that shown on Conrail's income tax return for the year immediately preceding the acquisition. The same Conrail "carryover" depreciable asset basis will be available if Conrail is sold publicly (although a publicly held Conrail will have no guarantee that such depreciable basis will not later be reduced in an IRS audit).

Norfolk Southern, Conrail and the advisors to the public investors essentially agree that Conrail will show a depreciable asset basis on its final federal income tax return of approximately $3 billion. Thus, this amount, when recovered through annual depreciation deductions following the acquisition of Conrail, will be available to offset Conrail's post-sale income subject to tax. In addition, Conrail will make capital expenditures for track, rolling stock and other capital assets following the sale by DOT, and these capital expenditures will result in additional depreciation deductions and investment tax credits which will reduce Conrail's post-sale taxable income.

It is important to keep in mind that net operating losses and excess investment tax credits that have arisen prior to the sale of Conrail by DOT will be cancelled under both the Norfolk Southern Memorandum of Intent and the terms of the public investors' offer. Thus, there will be no pre-sale net operating losses or investment tax credits to shelter post-sale Conrail income. Therefore, the Conrail depreciation deductions and credits that will reduce future tax revenues are solely the deductions claimed in years after the sale with respect to the depreciable basis in Conrail's assets as those assets existed on the date of the sale, plus the deductions and credits with respect to depreciable assets acquired following the sale.

Except for the possibility that the $3 billion carryover asset base might be adjusted downward on IRS audit if Conrail is publicly held (Norfolk Southern being protected by the DOT guarantee against any loss of tax deductions from such an IRS adjustment), the amount of depreciation deductions (and investment credits from future capital expenditures) initially available to both a Norfolk Southern-owned Conrail and a publicly held Conrail are exactly the same. The sole issue therefore concerning the potential loss of revenue to the federal government from these depreciation deductions and investment tax credits is the extent to which, and the time at which, they would be utilized by the respective parties to reduce tax liability following the sale of Conrail by DOT.

It is our conclusion that if Norfolk Southern acquires Conrail, all of the depreciation deductions and investment tax credits will be fully utilized at the earliest point they become available to reduce the tax liability of Conrail and Norfolk Southern and its affiliated corporations. Thus, we and CBO concluded that future federal tax revenues would be reduced. As indicated earlier, we had estimated this loss to be $366 million in present value terms based on the earlier Conrail economic projections.

By contrast, to the extent that the depreciation deductions and investment tax credits will not be utilized by a publicly held Conrail due to insufficient taxable income, there would be no loss in future tax revenues.

Norfolk Southern Utilization of
Depreciation and Investment Tax Credits

If Conrail is acquired by Norfolk Southern, the tax depreciation and investment tax credit benefits discussed earlier will offset taxable income of a post-sale Conrail; the amount of deductions and credits in excess of the amount needed to fully offset Conrail's income will be available to reduce taxes that Norfolk Southern would otherwise be required to pay. The excess deductions and credits will be available to offset Norfolk Southern's tax liability because Norfolk Southern can include Conrail on its consolidated federal income tax returns for post-acquisition taxable years and thus claim such excess deductions and credits to reduce the tax liability of the consolidated group of corporations.

It has been suggested at various times that the Internal Revenue Code constraints against trafficking in tax losses might impede Norfolk Southern's ability to reduce its tax liability following the acquisition of Conrail. In particular, there is a restriction under existing law that depreciation deductions will not be allowed to the extent that the carryover basis of an acquired corporation's assets exceeds the fair market value of those assets on the date of acquisition (the "built-in deduction" limitation). Although this limitation could be a potential constraint on Norfolk Southern's use of Conrail's depreciation deductions, fair market value is so difficult to determine that the Joint Committee on Taxation in reviewing this transaction was unable to conclude the degree to which this limitation might be

meaningful. In the event, however, that this restriction under existing law might impose an apparent constraint, it seems clear that it would not prevent full utilization of Conrail's depreciation deductions because as a practical matter, nothing would prevent Norfolk Southern from augmenting Conrail's share of taxable income of the consolidated group of corporations once Conrail is owned by Norfolk Southern. From my understanding of the facts, I conclude that there would be no effective legal constraint on "income shifting" in the context of a Norfolk Southern-owned Conrail.

Norfolk Southern apparently agrees with the conclusion that it will fully utilize the tax benefits from the Conrail depreciation deductions and investment tax credits. In the Congressional Budget Office letter to Chairman Danforth dated June 6, 1985, it is stated that while the Joint Committee staff has not been able to conclude with certainty that the "built-in deduction" limitation rules of existing law would not apply, "Norfolk Southern claims that it will be able to use the full depreciation deductions and has presented some materials to substantiate its claim."

Utilization of Depreciation Deductions and Investment Tax Credits by a Publicly-Held, Stand-Alone Conrail

If Conrail is sold to the public, the tax benefits from the depreciation deductions and investment tax credits will be utilized only to the extent that a stand-alone Conrail generates its own taxable income plus, to a limited degree, the extent to which Conrail could enter into leasing transactions with respect to new capital expenditures of rolling stock. This also would be the case if the government did not sell Conrail.

The extent to which a stand-alone Conrail is able to utilize the depreciation deductions from the carryover basis of Conrail assets in existence on the date of acquisition, and the depreciation deductions and investment tax credits arising from post-acquisition capital expenditures, is a direct function of the income generated by Conrail after the acquisition. To the extent there is insufficient income to utilize the tax benefits -- or stated differently, to the extent a net operating loss carryover and an investment tax credit carryover exists in any of the years following the acquisition of Conrail -- there will be increased future tax revenues as compared to the Norfolk Southern full utilization of such tax deductions and credits.

The net operating losses and excess investment tax credits not utilized by Conrail will not be available to reduce the tax liability of other corporations because Conrail will be an independent entity and will not be part of a consolidated group of corporations for tax purposes. Under the proposal for a publicly held Conrail, the percentage of Conrail stock which may be held by any one investor is restricted and this precludes the possibility that Conrail will be acquired by another consolidated group of corporations.

For all practical purposes, by virtue of covenants to be imposed by DOT, a publicly held Conrail will not be able to acquire businesses or assets which produce meaningful additional taxable income to utilize the net operating losses and excess investment tax credits. Under such covenants, Conrail will be required to maintain a minimum cash balance of $500 million plus the amount of any net additional debt incurred or preferred stock issued after the date Conrail is sold. The need to distribute cash dividends to investors will thus prohibit the use of long term debt or preferred stock to make an acquisition of taxable income-producing assets. Common stock could not be used to make such an acquisition because, as a practical matter, a business with sufficient earnings could not be found to support the additional dividends that would be required on the additional shares of common stock issued in the acquisition.

It has been suggested that even though a stand-alone Conrail could not utilize many of the depreciation deductions and investment tax credits, a portion of such tax benefits could be made available to other taxpayers through leasing transactions and thus would represent a loss in future tax revenues to the federal government. To an extent, this is correct. However, only new purchases of capital equipment may be leased (i.e., no part of the carryover basis of the Conrail assets on the date of the acquisition could be leased), and new acquisitions of track and other "special purpose" assets are not permitted to be leased under existing federal tax rules.

Railroad Retirement Taxes

The combination of Norfolk Southern and Conrail will have a direct impact on the Railroad Retirement System, with a revenue loss to the federal government through the year 2000 of approximately $245 million in present value terms (using a 10% discount rate).

Norfolk Southern has stated that over 1,800 jobs will be lost as a direct result of its acquisition of Conrail. 1/ In addition, workers on other railroads also will lose their jobs as a direct result of the transaction. We have once again reviewed the earlier job loss estimates and believe that at least 8,200 jobs will be lost on these other railroads due to diversion of traffic. Based on that reexamination, and based upon information filed recently with the ICC, we conclude this number is reasonable. Moreover, various union officials have stated that they believe 10,000 or more jobs will be lost.

1/ According to Norfolk Southern's recent filing before the Interstate Commerce Commission, these 1800 job losses do not include any Norfolk Southern or Conrail jobs that may be lost as a result of the planned divestitures to Guilford Transportation Industries, Inc. or to The Pittsburgh and Lake Erie Railroad Company. This figure also does not take into account any additional positions Norfolk Southern claims will be necessary to handle diverted traffic.

Any change in the composition of the labor force resulting from the combination of Norfolk Southern and Conrail will entail fewer railroad jobs and, unless there is a drop in total employment, more non-railroad jobs. This change will reduce receipts to the federal government because railroad employment taxes are collected only on wages paid to railroad workers. Employers of railroad workers pay Tier II taxes in 1985 at a rate of 13.75 percent on each worker's first $29,700 of compensation. This rate increases to 14.75 percent for 1986 and years following.

The Railroad Retirement Board has calculated the detrimental effect to the railroad retirement fund through the year 2000 if 10,000 jobs are lost. The Board expects a cumulative net reduction in the Tier II account balance of $1.9 billion. This estimate looks to Tier II only, and takes into account any reduction in railroad retirement benefits for these workers. It does not take into account any possible reduction in the Social Security Equivalent Account (the Tier I taxes), since the Tier I component of railroad retirement taxes is comparable to social security and it is assumed that all displaced railroad workers will obtain comparable employment in non-railroad jobs.

It is true that under the terms of the Memorandum of Intent, Norfolk Southern and Conrail workers directly affected by the NS/Conrail combination will be eligible for so-called New York Dock labor protection payments, which can be available for up to six years. Since these protection payments are subject to Tier II taxes, we have adjusted the Railroad Retirement Board estimate downward for the workers that Norfolk Southern claims will be eligible for New York Dock protection. It is important to keep in mind, though, that the Tier II fund will be permanently lower after the six years of protection payments expire. More significantly, New York Dock protection payments will not be available to the 8,200 workers on other railroads who lose their jobs as a result of the Norfolk Southern/Conrail combination.

Once the figure supplied by the Railroad Retirement Board is adjusted to take into account New York Dock payments, we then adjusted the present value of the total for income tax effects. Since excise tax payments such as railroad retirement Tier II payments are deductible by a railroad employer for income tax purposes, we have taken into account the income tax deductions foregone (and thus the increase in federal corporate income tax collections) in making our estimate.

A publicly held Conrail does not involve the job losses I have discussed, and thus we expect no employment impact that would affect receipts from railroad retirement taxes.

Wage Settlement Claims and
Payments to ESOP Beneficiaries

Under the Memorandum of Intent, Norfolk Southern has agreed to cause Conrail to pay $375 million to Conrail employees and beneficiaries of Conrail's Employees Stock Ownership Plan. This amount will be divided into two parts: a portion will be paid to settle outstanding wage claims of Conrail employees, and the balance will be paid in exchange for the ESOP's entire stock interest in Conrail. (The consummation of the purchase of the ESOP stock will be dependent upon specific enabling legislation since such a purchase is not permitted under the current ESOP rules.)

It has not been determined how the $375 million will be divided between the wage settlement and the ESOP purchase. To the extent allocated to the wage settlement, the payment made will be deductible to a Norfolk Southern-owned Conrail. To the extent the $375 million is paid for the purchase of the ESOP stock, no current deduction will be allowable.

Thus, a tax benefit to a Norfolk Southern-owned Conrail -- and a loss in future tax revenues to the federal government -- will result from the portion of the $375 million which is paid in settlement of wage claims. The Congressional Budget Office in its June 6 letter to Chairman Danforth stated that the allocation of the $375 million between the wage settlement and the ESOP purchase had not been determined and therefore the Joint Committee on Taxation estimated the revenue impact of this aspect of the transaction by assuming that $48 per share (an aggregate $212 million) would be paid for the ESOP stock (the same price as the government is to receive for its interest in Conrail). The Joint Committee on Taxation assumed that the remaining $163 million would be claimed as a deductible payment in the settlement of wage claims. (The Joint Committee on Taxation also concluded that in determining the net revenue loss from the wage settlement payment, the fact that the recipient employees would be taxed on the payments, although generally at a lower rate, must be taken into account. We agree with that conclusion.)

Previously, it had been suggested that a larger portion of the $375 million would be allocated to the wage settlement, thus leaving a smaller amount for the ESOP purchase, and thus increasing the tax deduction from this aspect of the transaction. This will not be known until Norfolk Southern makes public its proposal relative to this allocation.

Except to the extent that a publicly owned Conrail has sufficient taxable income to utilize fully the additional deductions arising from any payments made for past wage claims of Conrail employees, there will be no loss in future tax revenues resulting from this payment by a publicly held Conrail.

Appendix B—Review of Benefits for Conrail Employees

The Morgan Stanley proposal will ensure better treatment for Conrail's 90,000 current and former employees. Since the proposal preserves Conrail as an independent entity, it will avoid the job losses at Conrail Norfolk Southern and other railroads affected by a Norfolk Southern-Conrail, combination. Overall, it offers a more attractive package than the Norfolk Southern bid by retaining and enhancing the value of the Employees Stock Ownership Plan (ESOP), and by giving employees a mutual interest in the future of Conrail. By adding two labor representatives to the Board of Directors, the Morgan Stanley proposal will also provide employees a voice in Conrail's future.

The Morgan Stanley plan proposes to *provide a comprehensive financial package valued at about $440 million to Conrail agreement and non-agreement employees.* This would reflect added value to their current 15% ownership interest in Conrail through the ESOP as well as satisfaction of prior wage and stock claims. The plan would:

Retain the current Conrail ESOP. Participants would be able to retain their shares, and Conrail would offer participants the option to sell a portion of the shares available for distribution at the same $48 per share price paid for the government's interest in Conrail. At the value of $48 a share, the Conrail shares held by the ESOP would have a value of $210 million.

Provide $200 million in cash for agreement employees and about $30 million in cash for non-agreement employees. All employees would have the option of using these cash payments to participate in Conrails future by purchasing Conrail common stock at $48 per share.

Provide standard industry wages. The Morgan Stanley proposal contemplates that employees be paid standard industry wages.

Provide fair labor protection arrangements. Because the Morgan Stanley proposal will preserve Conrail as an independent entity, it will avoid the job losses associated with the consolidations by Norfolk Southern. Appropriate labor protection arrangements will be negotiated with Conrail's employee unions through the collective bargaining process.

Board Representation. Conrail's agreement employees will have two representatives on the Board of Directors.

The Morgan Stanley proposal offers a substantially more attractive package for Conrail's employees than the Norfolk Southern offer.

It offers current and former employees a total financial package of approximately $440 million, which will be for the benefit of agreement and non-agreement employees. The Norfolk Southern Memorandum of Intent offers $375 million to agreement employees.

It gives Conrail employees the option to sell a portion of their ESOP holdings. The Norfolk Southern plan would involuntarily force out the Conrail ESOP shareholding.

It would enhance job security. It has been estimated that the Norfolk Southern offer might result in the loss of as many as 10,000 jobs at Conrail, Norfolk Southern and other railroads affected by the Norfolk-Southern Conrail merger.

The Morgan Stanley proposal offers better treatment for Conrail's employees. The proposal offers Conrail employees compensation for wage claims, the option of retaining a financial interest in Conrail's future, and a voice on the Board of Directors. It will enhance job security by keeping Conrail independent and providing appropriate labor protection for the future.

It stands in sharp contrast to the Norfolk Southern plan the Memorandum of Intent. In fact, several beneficiaries of the Conrail ESOP recently brought an action against the Secretary of Transportation, Norfolk Southern and Conrail. The lawsuit alleges that the Secretary's action entering into the Memorandum of Intent contemplating the purchase of the 4.4 million ESOP shares at a valuation of $17 vs. $48 per share (an aggregate $135 million) represents a taking without fair and adequate compensation for which the government may be liable.

COMPARISON OF MORGAN STANLEY AND NORFOLK SOUTHERN PROPOSALS

		Morgan Stanley	Norfolk Southern
1.	**Value to Government**	**$1.8 billion, plus the value of warrants and additional tax on investor gains**	**$1.2 billion**
	Investor Cash	$1.2 billion	$1.2 billion
	Percent of Company Purchased	85% (15% ESOP interest preserved)	100% (15% ESOP interest "forced out")
	Conrail "excess cash"	Government will receive "excess cash."	Same
	Sharing with Government	Government will participate in any appreciation in Conrail value by receiving stock purchase warrants for one million Conrail shares and receiving taxes on investor gains.*	None
	Incremental Value from Elimination of Estimated Tax Losses Arising from Norfolk Southern Offer:		
	Depreciation of Conrail Assets	$366 million* (present value).	None
	Reduced Payments of Railroad Retirement (Tier 2) and Unemployment Taxes	$245 million (present value)	None
2.	**Tax Treatment**	No Conrail tax benefits will be available to any member of the investor group.	Norfolk Southern-Conrail combination will create substantial opportunities to shield non-Conrail income.
	NOL and ITC Carryforwards	Conrail net operating loss and investment tax credit carryforwards will be surrendered.	Same

Guarantee of Tax Basis	No special protection for tax basis.	DOT must guarantee tax basis of Conrail assets, even though similar railroad assets owned by Norfolk Southern are being questioned by the IRS.
Earnings and Profits Account	In order to assure that no tax free return of capital dividends will be paid, the earnings and profits balance will be given a $500 million balance.	No provision.
5. Labor Provisions		
Value of Financial Package	$440 million	$375 million
Treatment of ESOP	Participants could elect to retain ESOP shares or sell a portion of their shares to Conrail for the same $48 per share price paid to the government.	Involuntary "force-out" of existing Conrail ESOP for amount to be determined. ESOP fiduciaries to be relieved of normal fiduciary responsibilities in valuation of ESOP shares.
Settlement of Prior Claims	$200 million to agreement employees and approximately $30 million to non-agreement employees. In lieu of cash, employees could elect to participate in the investor group by purchasing additional shares of Conrail stock at $48 per share.	Payment of cash to agreement employees such that total of cash payment and ESOP purchase is $375 million.
Job Losses	Because the proposal would preserve Conrail as an independent entity, it will avoid the job losses resulting from consolidations in the Norfolk Southern-Conrail system and job losses on other affected railroads.	Job losses directly resulting from consolidation of Norfolk Southern-Conrail operations have been estimated to be up to 10,000 on an industry-wide basis.

	Morgan Stanley	Norfolk Southern
3. **Labor Provisions (cont.)**		
Labor Protection		
Merger - Related Job Losses	There will be no job losses as a direct result of the transaction.	Conrail employees terminated as a result of merger would receive New York Dock protection.
Other Labor Protection	Labor protection provisions are the subject of current collective bargaining.	One year wage protection for some Conrail employees adversely affected by the introduction of efficiencies.
Consolidation of Operations	An independent Conrail would maintain existing headquarters and other facilities.	Commitment to retain operating headquarters in Philadelphia and major shop facilities limited to 5 years.
Labor Representation on Conrail's Board of Directors	Conrail agreement employees will have two representatives on Conrail's Board.	None
4. **Covenants**		
Term	5 years.	Same
Capital Expenditures	Ensures annual capital expenditures of $350-$500 million.	Same.
Dividends	Payment of dividends limited to 40% of cumulative net income, calculated on a purchase accounting basis, permitting waiver for projected first two quarters' dividends.	Payment of dividends limited to 40% of cumulative net income, calculated on a purchase accounting basis, starting from the closing date.
	Prohibits future dividends unless $350 million capital expenditure requirement is met. (Refund requirement is impractical for publicly owned company.)	Requires refund to Conrail of prior dividends to Norfolk Southern or affiliates, if Conrail is unable to meet $350 million capital expenditure requirement.

	Cash Balance	Requires minimum $500 million cash balance following payment of dividends.	Same, but has no effect if no dividends are declared.
	Pension Fund	Maintains existing independent Conrail pension plan and does not permit termination.	Permits merger of Conrail pension plan, which is overfunded on a termination basis, with Norfolk Southern plan and subsequent termination.
5.	Ownership	Diverse initial investor group purchases the government's 85% in Conrail. Current and former employees would have the option to retain their current 15% beneficial ownership interest. Within 5 years, the investor group's share would be reduced to no more than 40% of outstanding shares through one or more public stock offerings with no single investor holding more than 10% of outstanding shares.	Norfolk Southern would acquire 100% control of Conrail, including termination of the existing ESOP.
6.	Anti-takeover	For 5 years from closing, no person will be permitted to acquire or increase its ownership to more than 10% of Conrail common stock.	No provisions.

Appendix D

CONRAIL VIABILITY: SUMMARY

The $1.2 billion cash commitment from the investor group is the strongest testimony to the economic viability of Conrail and to its future as a major independent rail carrier.

Changed Environment. The Staggers Act of 1980 and Northeast Rail Service Act of 1981 totally changed Conrail's operating environment by allowing the railroads to manage according to the changing needs of the marketplace and on a for-profit basis.

Unparalleled Turnaround. Conrail, because of its able management and cooperative labor groups, has achieved a financial turnaround unparalleled in railroad history. Even though tonnage declined 23% from 1977 to 1984, and despite the prolonged 1980-82 recession, Conrail recorded a financial turnaround of ovef $900 million, from a 1977 net loss of over $412 million to 1984 profit of $500 million.

Strong Performance in 1984. In terms of improvement in operating efficiency and net railway operating income, Conrail outperformed many other railroads during 1984. In a 1984 survey of shippers, conducted by Distribution Magazine, Conrail was voted the best railroad in the country in service, pricing and communication.

Superior First Quarter Performance. The first quarter performance in 1985 demonstrates Conrail's ability to withstand sudden cyclical economic downturns. Although carloads abruptly declined in this period, Conrail's ability to control cost allowed it to perform well and even to outperform its competitors in many ways.

Low Cost Producer. Conrail is the low cost producer of merchandise freight service in the northeast and midwest, largely because of its strong market position, lower train operating costs, modern plant and equipment, labor support and management.

Viability Forecast. Conrail's 1985-1989 projections support the case that Conrail will be viable as a publicly held company under the investor group proposal.

Strong Balance Sheet. The Morgan Stanley proposal results in a balance sheet that establishes Conrail as having one of the strongest capitalizations in the industry.

Viability and Growth Potential. Not only is Conrail viable as an independent enterprise, if business volume grows and new services are offered, Conrail is perceived to have attractive earnings potential.

LONG-TERM ECONOMIC VIABILITY OF CONRAIL

Introduction

The willingness of a high quality group of investors to commit $1.2 billion of their own funds to buy 85% of Conrail's common stock is testimony to the economic viability of Conrail and to its future as a major independent rail carrier.

In a deregulated environment, an independent Conrail will be able to earn net income and generate cash flow sufficient to service debt, pay dividends and maintain and improve Conrail's asset base. Moreover, under this privatization proposal Conrail will be a very strong credit and have access on favorable terms to capital markets around the world.

Conrail's recent record of performance and projected results support this conclusion. Particularly noteworthy has been Conrail's ability to adapt to a changing market environment, while steadily improving its productivity and profitability. As a result, Conrail has become the **low-cost producer of merchandise freight traffic** services in the northeast and midwest.

Deregulation and Conrail's Record of Performance

It is now widely recognized that many of the problems encountered by the U.S. rail industry, including Conrail, were the result of an outmoded regulatory environment. This environment changed totally with the passage of the Staggers Act of 1980 and The Northeast Rail Service Act of 1981.

These progressive Federal legislative initiatives gave the railroad industry the ability to manage according to the needs of the marketplace and on a for-profit basis. These steps set the tone for profitable railroading in the northeast for the first time in recent history, thereby protecting these vital rail services. Conrail had particular advantages in responding to the changing industry environment in the form of able management and cooperative labor groups.

The result has been a dramatic turnaround in profitability for Conrail even more remarkable when one realizes that the U.S. experienced a significant recession during the 1980-82 period. The following tables show the effect of Conrail's rehabilitation programs, as well as the results of a new drive for efficiency and productivity. This success is unparalleled in railroad history.

Selected Conrail Operating Statistics

Year	U.S. Industrial Production Index	% Change	Reported Net Profit/ Loss	Conrail Tonnage (millions)	% Change
1968 (1)	106.3	-	$ (42)	359	-
1977 (2)	138.1	-	(412)	267	-
1978	146.1	5.79%	(430)	263	(1.50)%
1979	152.5	4.38	(221)	270	2.66
1980	147.0	(3.61)	(244)	239	(11.48)
1981	150.9	2.65	39	220	(7.95)
1982	138.6	(8.15)	174	178	(19.09)
1983	147.6	6.49	313	182	2.25
1984	163.3	10.64	500	192	5.49

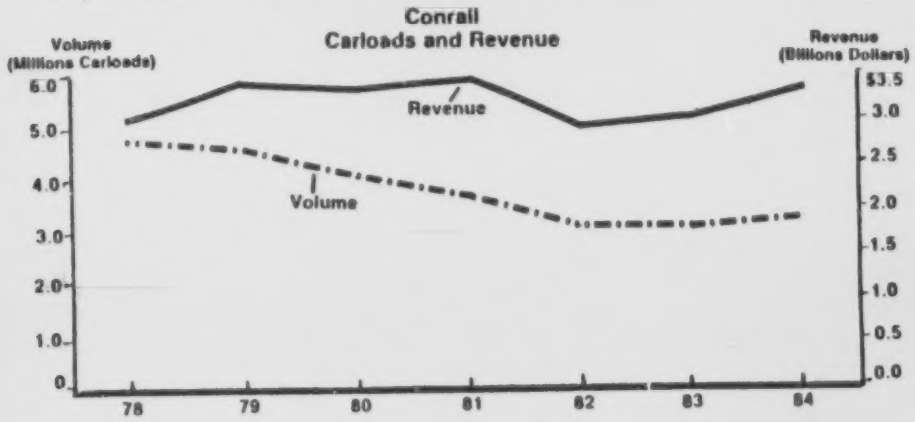
Year	Total Employees (Average)	Freight Employees (Average)	% Change	Tonnage Output/ Freight Employee	% Change
1968 (1)	121,576 (1)	NA	-	NA	-
1977 (2)	94,556	81,843	-	3,262.34	-
1978	91,276	78,332	(4.29)	3,357.50	2.92
1979	87,465	74,383	(5.04)	3,629.86	8.11
1980	79,560	65,691	(11.69)	3,638.25	0.23
1981	70,273	57,065	(13.13)	3,855.25	5.96
1982	57,678	45,405	(20.43)	3,920.27	1.69
1983	39,820	38,497	(15.21)	4,727.64	20.59
1984	39,044	37,911	(1.52)	5,064.49	7.13

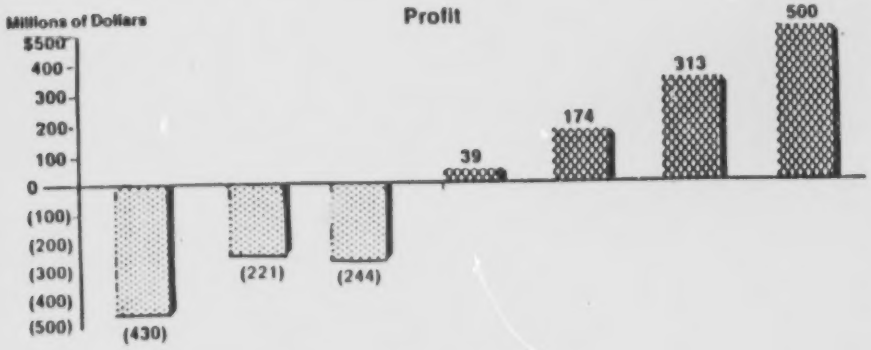
	Mileage Operated		Locomotives		Freight Cars	
Year	Route Miles	Track Miles	Number (4)	% Out Of Service	Number (4)	% Bad Order
1968 (3)	20,530	43,128				
1977	19,222	40,678	4,550	18.9%	144,632	13.2%
1978	19,013	40,341	4,561	18.4	132,260	12.7
1979	19,046	40,816	4,528	15.7	124,120	8.9
1980	18,902	39,988	4,521	14.6	117,340	10.2
1981	18,420	39,281	3,958	12.6	111,241	8.9
1982	17,103	37,056	3,754	13.6	107,234	4.8
1983	16,233	35,539	3,354	10.9	104,621	4.6
1984	15,468	34,269	2,783	8.6	95,118	3.2

In 1981, as tonnage declines continued, Conrail reduced costs and increased productivity to the point that it became modestly profitable. Over the past four years Conrail has reported increasing profits. The ability of Conrail to increase profits in a declining volume environment is graphically illustrated by the chart on the next page. Conrail has achieved this recent success in a competitive environment without government financial support.

NOTES: (1) In 1968, Penn Central Transportation Company, the principal predecessor company to Conrail, was created by the merger of the New York Central and the Pennsylvania Railroad.
(2) First full year of operations of Conrail.
(3) Penn Central only.
(4) At year-end.

CONRAIL'S PROFITABILITY IMPROVED DRAMATICALLY DESPITE DECLINING VOLUME





1984 Results for Conrail and Other Eastern Railroads

1984 was a good year for the railroad industry. Industrial production rose by over 10% and all railroads enjoyed substantially increased profitability. Conrail's performance stood out.

Revenues totaled $3.3 billion and exceeded company plans. Revenue ton miles grew 9.3%. Conrail's operating ratio, adjusted for industry wage levels and payment of state taxes, was 89.3%, in the mid-range of the major railroad carriers. Pre-tax income, adjusted on the same basis, was $405 million and year-end cash balances totaled $846 million.

Below are summary 1984 data:

	1984 Actual (Millions)	1984 Adjusted (1) (Millions)
Tonnage	192	192
Freight Revenues	$3,322	$3,322
Operating Income	450	355
Pre-tax Income	500	405
Net Income	500 (2)	288
Operating Cash Flow	695	600
Gross Capital Expenditures	550	550

NOTES: (1) 1984 restated to reflect return to industry scale wages ($55MM) (approximately $65MM of the total annual wage concessions of $120MM has already been accrued in 1984), payment of state taxes ($30MM) and labor protection payments ($10MM).

(2) Conrail is currently required to provide for Federal income taxes in its financial reports. If Conrail had had no extraordinary tax credit in 1984, its net income would have been $340 million.

Conrail's 1984 performance compared favorably with that of the Chessie System and the Norfolk Southern, both of which also had good years.

Conrail's standing in the industry in 1984 reflected a very solid position.

	Conrail (1)	Chessie System	Norfolk Southern
1984 Tonnage (MM)	192	205	260
% Increase over 1983	5.2%	9.5%	10.3%
Freight Revenues ($BN)	$ 3.32	$ 2.10	$ 3.40
% Increase over 1983	9.8%	12.1%	11.8%
Net Railway Operating Income ($MM)	$ 355	$ 232	$ 734
% of Increase over 1983	288.6%	65.7%	35.0%
Operating Ratio	89.3%	89.5%	79.2%
Percentage Point Improvement over 1983	6.6	3.4	3.5

NOTE: (1) 1984 and 1983 adjusted for industry scale wages, payment of state taxes and labor protection payments.

Reasons for Conrail's Success

The key to Conrail's strong performance has been its ability to down-size its business and cost structure and to adapt to lower tonnage volumes and a changed marketplace. Central to Conrail's improvement were the following:

1. Traffic demand stabilized and the mix of commodities changed from heavy dominance on boxcar-related traffic to service-oriented products and intermodal business.

2. Excess route, track and yard mileage was dramatically reduced, consistent with traffic demands. In 1984, Conrail's traffic density (revenue ton miles per mile of road operated), a measure of such utilization, was 13% higher than in 1980.

3. Plant and equipment have been replaced, rebuilt, and modernized to a level equal to or better than other U.S. railroads. Capital expenditures in the last five years equalled $2.19 billion compared with $1.37 billion for the Chessie System and $2.00 billion for Norfolk Southern.

4. Government regulation eased, largely as a result of the Staggers Act, enabling rational pricing and service improvements. In a shipper survey conducted in 1984 by Distribution Magazine, Conrail was voted the best railroad in the country - best in service, communication and pricing.

5. All commuter service has been transferred to commuter agencies; from 1976 until 1982, the last years of passenger service, the operations sustained substantial losses.

6. Under the provisions of the Northeast Rail Service Act, since 1981 Conrail has been able to eliminate excess firemen and excess second and third brakemen, resulting in considerably lower crew costs. Employee productivity has improved significantly.

First Quarter 1985: Conrail's Ability to Withstand Weak Cyclical Conditions

The railroad industry is a highly cyclical business, with results driven by industrial production levels and changes in inventories. How any given company performs in an unexpected business downturn or recession is key to understanding its long-term viability.

In 1985, just such a downturn in Conrail's business has occurred, and Conrail has performed well. Despite widely held expectations of a business expansion in 1985, tonnage has actually declined. The combination of inventory adjustments - some mild (such as retail) and some severe (such as coal), the strong dollar, favoring imports over domestic products, and severe winter weather conditions caused lower tonnage levels in the first quarter 1985 versus the first quarter 1984. This condition continued in April 1985.

Conrail's performance during first quarter 1985 was strong and compares favorably with the other eastern railroads. A summary of key financial statistics is presented below:

Measures of Efficiency and Productivity

	Conrail						Norfolk Southern						Chessie System					
	1984 (1)	1983 (1)	% Change	1985 Q1	1984 Q1 (1)	% Change	1984	1983	% Change	1985 Q1	1984 Q1	% Change	1984	1983	% Change	1985 Q1	1984 Q1	% Change
Revenues Ton Miles/ Employee (000's)	2,026	1,826	11.0%	546.0	527.0	3.2%	2,437	2,274	7.2%	639	691	(7.5)%	2,195	1,796	22.2%	567	550	3.1%
Revenue/Employee	$49,140	$39,913	11.9	$13,406	$12,899	2.2	$92,758	$83,458	11.2	$24,381	$25,668	(5.0)	$78,039	$66,621	17.1	$21,373	$21,335	1.1
Gross Ton Mile per Freight Train Hour (000's)	91.6	87.2	5.0	92.6	87.9	5.1	95.7	98.9	(3.2)	91.9	96.4	(4.7)	93.6	88.6	5.6	94.8	90.7	4.5
Gross Ton Miles/Transp. Dept. Manhours (000's)	3.4	3.2	6.3	3.2	3.2	0.0	4.2	4.0	5.0	4.1	4.2	(2.4)	4.7	4.4	6.8	4.7	4.6	2.2
Transportation Ratio	42.1%	44.0%		44.0%	43.6%		35.3%	37.5%		36.9%	35.7%		44.1%	44.2%		43.1%	43.6%	
Wage Ratio	33.9	36.7		37.1	36.3		33.8	35.8		35.1	34.7		39.1	40.1		42.6	40.3	
Operating Ratio	89.3	95.9		96.2	93.8		79.2	82.7		83.0	81.3		89.3	92.9		93.0	92.7	

NOTE: In the first quarter 1985, Conrail improved its ratio of Revenue Ton Miles to Employees by 3.2%, while Norfolk Southern's same ratio deteriorated 7.5% and Chessie's improved 3.1%. Similarly, Conrail's revenues per employee rose 2.2% against a decline of 5.0% registered by Norfolk Southern and an improvement of 1.1% for Chessie. Both measures of Gross Ton Miles improved for Conrail but not for Norfolk Southern.

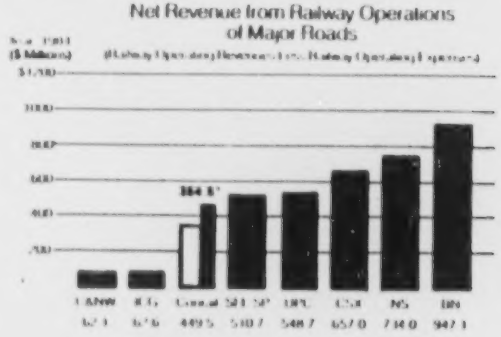
(1) Transportation, wage and operating ratios restated to reflect return to industry scale wages, accrual of state taxes, and labor protection payments.

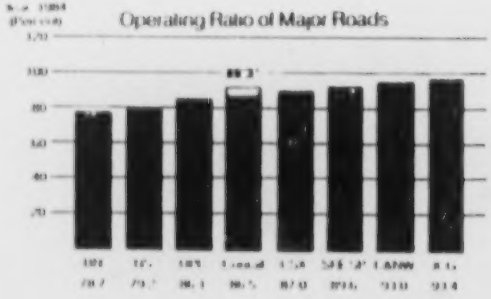
SUMMARY FIRST QUARTER COMPARISON OF EASTERN RAILROADS

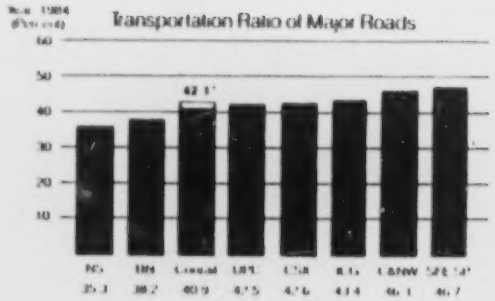
	Conrail			Norfolk Southern			Chessie System		
	1985	1984 (1)	% Change	1985	1984	% Change	1985	1984	% Change
Freight Volume (000's)									
Coal	143.8	175.5	(18.1)%	328.1 (3)	353.6 (3)	(7.2)%	288.0	340.0	(15.3)%
Merchandise (2)	553.2	608.3	(9.1)	598.9 (3)	617.1 (3)	(2.9)	304.0	303.0	0.3
Total Carloadings	707.0	783.8	(9.8)	927.0	970.7	(4.5)	592.0	643.0	(7.9)
Revenue Ton Miles	18.3	19.4	(5.7)	22.6	23.8	(5.0)	13.6	14.1	(3.5)
Freight Revenues ($MM)									
Coal	107.0	131.0	(18.3)	$ 281.2	$ 300.6	(6.5)%	$ 222.8	$ 256.0	(13.0)%
Merchandise (2)	653.0	680.0	(4.0)	551.8	554.1	(0.4)	272.0	263.5	3.2
Other	29.0	30.0	(3.3)	29.2	30.0	(2.7)	19.9	24.3	(18.1)
	$ 789.0	$ 841.0	(6.2)%	$ 862.2	$ 884.7	(2.5)%	$ 514.7	$ 543.8	(5.4)%
Operating Expenses	743.0	789.0	(5.8)	715.2	721.4	(0.9)	488.8	503.9	(3.0)
Operating Income	$ 46.0	$ 52.0	(11.5)%	$ 147.0	$ 163.3	(10.0)%	$ 25.8	$ 39.8	(35.2)%
Operating Ratio	94.2%	93.8%		83.0%	81.5%		95.0%	92.7%	
Employees	33,562	36,655	(8.4)%	35,363	34,467	2.6%	23,900	25,700	(7.0)%
Manhours (MM)	20.7	22.5	(8.0)	18.9	20.3	(6.9)	13.6	14.4	(5.6)
Gross Wages (MM)	$ 298.9	$ 317.7	(5.9)	$ 285.5	$ 280.1	1.9	218.0	219.1	(0.5)

NOTES: (1) Restated to reflect industry scale wages and accrual of state taxes.
(2) Merchandise includes all non-coal items.
(3) Breadkown of carloadings between coal and merchandise freight estimates based on coal cars loaded and received for the first thirteen weeks of 1985 and 1984; as reported by the Association of American Railroads.

Comparison of U.S. Class I Roads with 1984 Operating Revenues Over $500 Million







As the data on freight volume show, the economic decline was quite steep. Conrail's own carloadings declined 9.8%, more than Norfolk Southern (down 4.5%) and the Chessie System (down 7.9%). However, Conrail performed far better in terms of expense reduction than the Norfolk Southern and the Chessie System. Operating income fell 11.5%, much less than the Chessie System (down 35%) and performed nearly as well as Norfolk Southern (down 10%). This was accomplished by Conrail in the following ways:

- Conrail registered a 6.2% decline in operating revenues. The 9.8% volume decline was offset in part by a 0.6% increase in freight rate levels year over year, and a 3% increase in revenues attributable to length of haul and freight tonnage mix changes. The 6.2% change in revenues represented a $52 million decline. Conrail's expenses declined by $46 million (compared with 1984 first quarter expenses adjusted for the payment of comparable wages and state taxes).

- Conrail offset $29 million of the $52 million revenue decline by volume variable cost reductions, $12 million by new efficiencies, and another $5 million from lower fuel costs. This is a considerable financial achievement in the face of an unexpected business decline and attests to Conrail's ability to manage for profit.

- In addition, severe winter weather added $7 million to costs. Despite this, Conrail's operating ratio stood at 94.2% versus 93.8% in the first quarter of 1984. This ratio compares favorably with the Chessie System, which was at 95.0% versus 92.7%, but is significantly higher than that of the Norfolk Southern, whose operating ratio was 83.0% versus 81.5% in the comparable 1984 period.

By other operational measures, Conrail continued to strengthen its competitive position and to improve its productivity in the first quarter of 1985, demonstrating that these gains can be made even in an adverse economic environment. Comparative operating statistics for eastern railroads are presented below. In addition, summary operating statistics for a broader group of major railroads (initially prepared by Norfolk Southern) are presented on the preceding page.

Conrail is the Low-Cost Producer of Merchandise Freight Traffic Services in the Northeast and Midwest

The cumulative effects of investment in new plant and equipment, deregulation, cooperation from labor and strong management (as demonstrated by 1984 and 1985 performance) are that Conrail is now the low-cost producer of merchandise freight traffic services in the northeast and midwest. This is even true in truck-competitive markets. As the low-cost producer and because it is well managed, Conrail can adjust to cyclical turns in the economy - the key to Conrail's viability.

It is important to remember that Conrail's mix of business is more heavily oriented toward the competitive, non-coal (largely merchandise) traffic (83% in 1984), whereas Chessie's merchandise traffic accounted for 52% of revenues in 1984, and Norfolk Souuthern's 66%. However, the more profitable activity for Norfolk Southern is the coal business, because Norfolk Southern runs long unit coal trains downhill from big mines to tidewater port facilities. Thus, while Norfolk Southern has a lower operating ratio than Conrail, it is likely that the operating ratio for its merchandise traffic business alone, if it were available, would well exceed Conrail's operating ratio.

Conrail is the low-cost producer of merchandise freight service in its market, largely because of its strong market position, which lowers unit costs, as well as its modern plant, labor support and other factors.

- Conrail has the best East-West core routes, which have recently been modernized.

- Conrail reaches the major centers of consumption and production, as well as major interchange points for inter-regional freight movements in the most direct and cost-efficient ways:
  - Conrail serves 15 states and 39% of the U.S. population
  - Conrail connects with the five major rail systems that serve the rest of the country
  - three-fifths of the states in the U.S. generate $50 million or more in railroad business to or from Conrail points each year.

- Conrail has a significant share of the major East/West merchandise freight market in the Eastern District (Northeast quadrant of the U.S.).

Total Merchandise Freight	42%
Intermodal	59%
Automotive	41%
Metals	55%
Chemicals	40%

- Conrail's equipment is in excellent condition and has the capacity to meet the needs of shippers.
  - From 1977 to 1984 Conrail reduced the percentage of locomotives out of service from 18.9% to 8.6%.
  - Over the same period, Conrail reduced freight cars out of service from 13.2% to 3.3%.

- Conrail's train operating labor content is lower than that of either of the other eastern railroads.

	1984 Crew Size	
	Road and Local Trains	Yard
Conrail	3.60	3.27
Chessie	4.37	4.45
Norfolk Southern	4.34	4.25
Conrail Crew Size Advantages		
Chessie	18%	27%
Norfolk	17%	23%

- Conrail's total transportation cost to shippers is lower than that of trucking companies in major markets and traffic lanes, because of generally lower fuel costs for railroad intermodal shipments.
- Moreover, in 1984 Conrail's cost to shippers was lower than the average of major truckers.

1984	Fuel Cost per Trailer Mile
Truck (Tractor-trailer)	14¢
Rail Intermodal-(Conventional)	7¢
Rail Intermodal (New Technology)	4¢

1984	Cost to Shipper per Mile
Conrail's Intermodal Traffic	$1.17
Major Truckload Carriers	1.25

- Conrail's workrules, achieved by the cooperation of forward-looking labor and good management through free collective bargaining processes, are the envy of its competitors. These rules, vital ingredients of management's ability to deal with changing tonnage, allow quick responses to many changes in business volume without having to resort to lengthy procedures.

With Operating Crafts, Conrail

- can establish new terminals, which most other railroads must negotiate.
- has the ability to combine crew runs (inter-divisional runs).
- can consolidate lists of extra employees.
- requires fewer firemen and second brakemen on crews.
- has a more economic rule for transporting out-of-service crew (deadheading rules).
- can consolidate pools of crews.
- has single system-wide agreement with each craft.

With Non-Operating Crafts, Conrail

- does not have onerous and expensive job stabilization agreements.
- has extensive flexibility to transfer work.
- has single system-wide agreement with each craft.

Conrail's Forecasted Performance

Consistent with past practice, on June 7, 1985 Conrail submitted its Five Year Outlook for the years 1985-1989 to the United States Railway Association ("USRA"). This outlook is a revision of the Five Year Outlook submitted to the USRA one year earlier (on June 6, 1984), which incorporated a cyclical decline in tonnage in 1986 and 1987. The recent outlook, which reflects a more current assessment for the economy, is generally more optimistic than that of a year ago. Specifically, it is now anticipated that industrial production will continue to increase throughout the period and that, on average, Conrail's tonnage will increase 0.9% annually, from a level of 182 million tons in 1985 to 189 million tons in 1989. Overall, these projections have been based on the assumption that rail traffic stabilizes, returning in 1987 to tonnage levels comparable to 1984.

Although Conrail is now projecting somewhat lower tonnage for 1985 than the 185 million tons presented in the Morgan Stanley investor group's May 14, 1985 proposal, continuing improvements in operating efficiencies are projected to result in only slightly lower income for the full year.

Morgan Stanley has had the opportunity to make only a limited review of the new Five Year Outlook. However, since it reflects a more current view of the outlook for the economy, Morgan Stanley believes it provides a preferable basis for discussion of Conrail's viability. The projections, which appear on the following pages, clearly support the case that Conrail will be viable as a publicly held company under the public interest covenants. At either the $350 million or $500 million annual capital spending amounts called for by the public interest covenants, Conrail's cash balances build over the period. Under the new Five Year Outlook Conrail can also meet the public interest covenants with only a minor variance in management's new capital expenditure forecast, a variance that in no way will impact the long-term viability of the company.

These projections, pro-forma for the Morgan Stanley investor group proposal, are presented in the following pages.

The following assumptions underlie Conrail's June 1985 Projections:

General Corporate Assumptions:

- Conrail will become a private sector company as of January 1986.
- Existing debt (debentures and preferred stock) held by the United States will be cancelled.
- For federal income tax purposes (based on existing tax legislation):
  - Operating losses (for tax purposes) and investment tax credits, if any, will commence to be available from January 1986 (no carryovers);
  - Frozen asset base (affecting track assets) continues to be available for tax purposes;

- Asset basis for tax purposes also continues to be available.
- Any required federal income taxes will be booked as charges against net income, including deferred taxes.

o State taxes will be required starting in 1985.

o Employee protection obligations will commence in 1986.

Operating Assumptions:

o There will be no major yard or shop closings.

o Efficiency Improvements

- Operations: overall average improvement of about 2% per year.

Pro Forma Assumptions Made by Morgan Stanley for the Investor Group Proposal:

o Purchase by the investor group of 85% of Conrail for $1.2 billion closes December 31, 1985.

o Annual common stock dividends are approximately $118 million, reflecting the repurchase by Conrail of about 800,000 shares currently held by the employees through the Employee Stock Ownership Plan.

o At or near closing:

- $230 million of Conrail's cash is used in settlement of prior wage claims.
- $38 million of Conrail cash is estimated to be used in the repurchase of shares held by the employees through the Conrail ESOP.
- $100 million is estimated to be returned to the government as "excess cash."
- $7 million of Conrail cash is used for miscellaneous expenses.

o Interest income is reduced as a result of lower cash balances.

o For pro-forma purposes, capital expenditures are presented at a level of $350 million for years 1986-1989 in Case I and $500 million in Case II. Case III presents the approximate maximum capital spending level permitted under the covenants and demonstrates the viability of Conrail with capital spending at a minimal variance from management estimates.

o Adjustments have been made in interest income, depreciation and interest expense from management's projections to reflect the adjustment in capital expenditures and associated financing and payment of dividends.

SUMMARY PROJECTIONS

(Pro Forma for the Morgan Stanley Investor Group Proposal)
($ Millions)

	CASE I - $350MM CAPITAL EXPENDITURES					CASE II - $500MM CAPITAL EXPENDITURES					CASE III - APPROXIMATE MAXIMUM CAPITAL EXPENDITURES UNDER THE COVENANTS				
	At December 31,					At December 31,					At December 31,				
	1985	1986	1987	1988	1989	1985	1986	1987	1988	1989	1985	1986	1987	1988	1989
Tonnage (Millions of tons)	182	186	190	190	189	182	186	190	190	189	182	186	190	190	189
Income Statement															
Revenues	$ 3,206	$ 3,371	$ 3,541	$ 3,688	$ 3,809	$ 3,206	$ 3,371	$ 3,541	$ 3,688	$ 3,809	$ 3,206	$ 3,371	$ 3,541	$ 3,688	$ 3,809
Operating Income (2)	402	413	455	484	503	402	413	455	484	503	402	413	455	484	503
Other - Net	55	10	31	55	73	55	(1)	12	22	26	55	(2)	(5)	(7)	(15)
Pretax Income	$ 457	$ 423	$ 486	$ 539	$ 576	$ 457	$ 412	$ 467	$ 506	$ 529	$ 457	$ 411	$ 450	$ 477	$ 488
Income Taxes (3)	-	(121)	(150)	(174)	(191)	-	(104)	(129)	(147)	(158)	-	94	109	120	122
Net Income	$ 457	$ 302	$ 336	$ 365	$ 385	$ 457	$ 308	$ 338	$ 359	$ 371	$ 457	$ 317	$ 341	$ 357	$ 366
Cash Flow															
Sources:															
Net Income	$ 457	$ 302	$ 336	$ 365	$ 385	$ 457	$ 308	$ 338	$ 359	$ 371	$ 457	$ 317	$ 341	$ 357	$ 366
Non Cash Items	211	365	365	383	395	211	336	356	374	386	211	329	367	365	375
Funds from Operations	$ 668	$ 667	$ 701	$ 748	$ 780	$ 668	$ 642	$ 694	$ 733	$ 757	$ 668	$ 646	$ 688	$ 722	$ 741
Uses:															
Capital Expenditures	$ (359)	$ (350)	$ (350)	$ (350)	$ (350)	$ (359)	$ (300)	$ (500)	$ (500)	$ (500)	$ (359)	$ (609)	$ (631)	$ (651)	$ (638)
External Equipment Financing	116	81	81	81	81	116	115	115	115	115	116	146	167	161	145
Debt Repayments	(130)	(129)	(123)	(122)	(123)	(130)	(129)	(129)	(131)	(135)	(130)	(132)	(137)	(141)	(145)
Cash Used for payments to labor and the government	(375)	-	-	-	-	(375)	-	-	-	-	(375)	-	-	-	-
Dividends	-	(89)	(118)	(118)	(118)	-	(89)	(118)	(118)	(118)	-	(89)	(118)	(118)	(118)
Other - Net	36	10	5	-	(3)	36	10	5	-	(3)	36	10	5	-	(3)
Total Uses	$ (894)	$ (677)	$ (505)	$ (509)	$ (513)	$ (894)	$ (593)	$ (627)	$ (634)	$ (643)	$ (894)	$ (674)	$ (714)	$ (749)	$ (761)
Ending Cash Balance	$ 620	$ 790	$ 986	$ 1,223	$ 1,490	$ 620	$ 669	$ 736	$ 835	$ 949	$ 620	$ 592	$ 566	$ 539	$ 519

Notes:

(1) Reflects 4% reduction in capital expenditures in years 1986-1989. No adjustments to financing assumptions or depreciation have been made.

(2) Operating income reflects industry scale wages and payment of state taxes in all years, and labor protection payments in years 1986-1989.

(3) For purposes of the pro-forma, all taxes are assumed to be deferred.

SUMMARY PROJECTIONS

(Pro Forma for the Morgan Stanley Investor Group Proposal)

($ Millions)

	CASE I - $350MM CAPITAL EXPENDITURES					CASE II - $500MM CAPITAL EXPENDITURES					CASE III - APPROXIMATE MAXIMUM CAPITAL EXPENDITURES UNDER THE COVENANTS				
	At December 31,					At December 31,					At December 31,				
	1985	1986	1987	1988	1989	1985	1986	1987	1988	1989	1985	1986	1987	1988	1989
Balance Sheet															
Net Assets															
Cash	$ 620	$ 790	$ 986	$ 1,225	$ 1,490	$ 620	$ 669	$ 736	$ 835	$ 969	$ 620	$ 592	$ 566	$ 539	$ 519
Other Current Assets															
Less Current Liabilities	(241)	(211)	(176)	(136)	(91)	(241)	(211)	(176)	(136)	(91)	(241)	(211)	(176)	(136)	(91)
Net Working Capital	$ 379	$ 579	$ 810	$ 1,089	$ 1,399	$ 379	$ 458	560	699	878	$ 379	$ 381	$ 390	$ 403	$ 428
Other Assets, Net	4,837	4,802	4,747	4,674	4,589	4,837	4,963	5,067	5,153	5,227	4,837	5,077	5,321	5,567	5,790
Net Assets	$ 5,216	$ 5,381	$ 5,557	$ 5,763	$ 5,988	$ 5,216	$ 5,421	$ 5,627	$ 5,852	$ 6,085	$ 5,216	$ 5,458	$ 5,711	$ 5,970	$ 6,218
Represented by:															
Long-term Debt	$ 844	$ 796	$ 754	$ 713	$ 671	$ 844	$ 830	$ 816	$ 800	$ 780	$ 844	$ 858	$ 888	$ 908	$ 908
Common Shareholders' Equity	4,372	4,585	4,803	5,050	5,317	4,372	4,591	4,811	5,052	5,305	4,372	4,600	4,823	5,062	5,310
Total Capitalization	$ 5,216	$ 5,381	$ 5,557	$ 5,763	$ 5,988	$ 5,216	$ 5,421	$ 5,627	$ 5,852	$ 6,085	$ 5,216	$ 5,458	$ 5,711	$ 5,970	$ 6,218
Debt/Total Capitalization	16%	15%	14%	12%	11%	16%	15%	15%	14%	13%	16%	16%	16%	15%	15%

Independent Review of Conrail Forecasts

Conrail's June 1984 projected financial results were reviewed and effectively endorsed by the United States Railway Association (USRA), the third such review by this Congressionally mandated organization. In his letter of April 1, 1985, Mr. Stephen Berger, Chairman of the Board of USRA, wrote to the Honorable John D. Dingell, Chairman, Committee on Energy and Commerce, as follows:

> "...As you requested, estimates were made of Conrail's earnings and cash flow as an independent entity over the next four years. Using what I regard as a very conservative approach, the staff predicts modest but solid profits for Conrail...
>
> Conrail has exceed expectations period after period Comforted by traffic stability and indeed some growth, Conrail has added two more years of cost reduction, and therefore significant profit improvement, to the 1981-82 experience. By using the tools granted by N.E.R.S.A. and skillfully employing the opportunities afforded by the Staggers Act, Conrail has become a financially viable railroad efficiently serving its customers and the region.
>
> Thus while the financial results of the present staff analysis, our third look at Conrail's future, are similar to those described in our profitability determination, the railroad portrayed in the staff report is a fundamentally stronger entity than the one we analyzed in 1983. The staff report shows Conrail maintaining future profitability while paying industry-scale wages, state taxes and labor protection expenses during a four year period containing a recession cycle.
>
> This outlook, combined with Conrail's now reasonably prolonged success at both cost containment and marketing innovation, permits a much less qualified judgment that Conrail's future is secure. The major risk factor remains the long-term record of declining rail traffic in Conrail territory, with no assurance that the trend has been arrested or reversed. But barring a rollback of Staggers Act deregulation of the industry, it now can be said that Conrail possesses the tools and has demonstrated the necessary skills to remain viable even if traffic declines.
>
> In other words, as Congress now considers proposals for selling the common stock of Conrail held by the government, it can do so knowing that the object of this discussion is no longer a patient. In a deregulated environment, Conrail has proven that it is profitable, stable and competitive."

It is contemplated that the USRA will review the newly released 1985-1989 projections, in due course.

Financial Resources

Conrail will be financially strong subsequent to a privatization including a public offering. Conrail will combine a strong balance sheet and operating income with a credit profile of the highest quality.

In addition to its own cash resources, Conrail will have access to worldwide money and capital markets on favorable terms. The availability of funds to Conrail from the financial markets is an important aspect of the Company's long-term viability.

Based on projections which assume $500 million in capital expenditures in years 1986-1989, Conrail will have the following illustrative pro forma financial statistics:

	Conrail Pro Forma for Public Offering Transaction					
	1985	1986	1987	1988	1989	Target Ratios (1)
Debt and capitalized leases/ capitalization	16%	15%	15%	14%	13%	30-35%
Pretax coverage of fixed charges	5.6x	5.0x	5.6x	5.9x	5.9x	2.5-3.5x
Operating cash flow/ Debt and leases	79%	77%	85%	92%	99%	35-45%
Cash balance ($ millions)	$ 620	$ 669	$ 736	$ 835	$ 949	

Note: (1) As estimated by Morgan Stanley to achieve "AA" credit rating on equipment debt.

Conrail's balance sheet under this proposal will be one of the strongest in the railroad industry. Indicative of Conrail's financial strength is its pro forma debt-to-book capitalization ratio of 16% in 1985 as compared to the predominantly higher 1984 debt-to-book capitalization ratios for other major railroads presented below. Moreover, Conrail's other pro-forma credit statistics for 1985 compare very favorably to the following major railroads.

Selected Financial Statistics (1)

	Burlington Northern	CSX	Norfolk Southern (2)	Santa Fe Southern Pacific	Union Pacific
Debt and capitalized leases (3)/capitalization	33.5%	30.5%	17.5%	22.3%	29.1%
Operating cash flow/ total debt	58%	48%	94%	75%	56%
Pretax coverage of fixed charges	4.1x	2.9x	9.4x	4.7x	4.3x

NOTES:
(1) Source: Compustat for year end 1984.
(2) Norfolk Southern's current financial leverage is expected to increase as a result of anticipated borrowings to finance its acquisition of Conrail.
(3) Long-term debt includes minority interest.

Conclusion

A viable Conrail returned to the private sector as an independent entity will use its considerable marketing, operational and financial resources to:

continue to provide a high level of innovative service;

maintain a competitive rail environment in the northeast and midwest;

generate attractive financial returns to shareholders while continuing to support capital spending and productivity enhancements; and

improve employment conditions for the long-term.

Appendix E

ANTI-TRUST CONSIDERATIONS

1. **The Proposed Norfolk Southern-Conrail Combination Conflicts With Established Congressional Policies of Promoting Effective Rail Competition.**

Following the collapse of the Penn Central system, Congress enacted laws designed to preserve rail transportation service in the northeast and has consistently emphasized the importance of promoting effective competition. Consistent with this policy, the Northeast Rail Service Act of 1981 directed the Secretary of Transportation to plan for the return of Conrail to the private sector and expressed a clear preference for its continuation as an ongoing enterprise. Specifically, the House Energy and Commerce Committee found:

> A balanced and competitive transportation system is essential to the entire country, and in selling the assets of Conrail, the Secretary must not harm the delicate competitive balance of the transportation system of the country. (Report No. 97-153, 97th Congress, June 18, 1981, p. 9)

The proposed Norfolk Southern-Conrail combination is conceded by the Justice Department to raise serious competitive concerns. A number of experts have stated that the anti-competitive consequences are, in fact, far more serious than the Justice Department admits. Proposed enabling legislation to permit the Norfolk Southern-Conrail combination does not address these problems directly and would delay the resolution of specific divestiture plans until after congressional approval. Furthermore, the legislation would preclude subsequent judicial review.

2. **Anti-Competitive Effects Have Been Understated.**

Even though the Department of Justice has expressed support for the proposed Norfolk Southern-Conrail combination, if certain conditions are met, it has voiced serious concerns about the anti-competitive effects of the transaction:

> On the basis of our independent investigation, we have concluded that without appropriate divestiture, the proposed merger would violate both Clayton Act and Interstate Commerce Act merger review standards. The merger would have a significant adverse effect on competition for the transport of commodities to and from a number of locations in several states with the greatest effect occuring at locations along an east-west rail corridor running between Buffalo and Pittsburgh in the east and St. Louis and Chicago in the west. (Emphasis added) (Letter of January 29, 1985 from Assistant Attorney General McGrath to Secretary of Transportation Dole.)

The methodology applied by the Justice Department in analyzing the proposed Norfolk Southern-Conrail combination departs materially from traditional

antitrust analysis. It substantially understates the competitive problems that flow from the combination and overstates the curative effects of proposed divestitures. In fact, the Justice Department's analysis is inconsistent with its own recently revised merger guidelines.

The Justice Department is contemporaneously involved in a proceeding before the Interstate Commerce Commission relating to the proposed Santa Fe-Southern Pacific merger. In that proceeding, the Justice Department has advocated a methodology for examining the competitive consequences of rail mergers, which differs materially from that applied to the Norfolk Southern-Conrail combination. In that proceeding, the Justice Department's expert admitted that the methodology applied there was different from that applied to the Norfolk Southern-Conrail combination and stated that the methodology used in Norfolk Southern-Conrail analysis was, in his view, not correct.

Former Assistant Attorney General for Antitrust, Thomas Kauper, a recognized antitrust scholar and distinguished professor at the University of Michigan Law School, has also reviewed the Antitrust Division's analysis of the Norfolk Southern-Conrail combination and, in a letter dated March 29, 1985 to the Honorable Strom Thurmond, Chairman of the Senate Judiciary Committee, stated that the Justice Department's analysis is unreliable and deficient.

3. Limited Divestiture Will Not Cure the Problem.

Even if the Justice Department's analysis of competition is assumed to be correct, the limited divestiture which has been proposed as a solution is of questionable effectiveness. Although neither the Justice Department nor Norfolk Southern have come forward with a specific divestiture plan, it is likely that some assets of Conrail will be divested to the Pittsburgh & Lake Erie and the Guilford systems. Many of the assets and routes that would be divested are likely to be of low-quality, in disrepair, and, in general, constitute circuitous and non-competitive routes when measured against those of the Norfolk Southern-Conrail combination.

Further, the assets and routes apparently proposed for divestiture will not be viable in the absence of an infusion of very large amounts of capital. Thus, even if the only competitive problems are those admitted by the Justice Department and the problems can be solved by divestiture of these limited assets, such divestiture could be effective only if the recipients of the divested assets have the financial resources to utilize the assets as part of a competitive system. Neither of the two most likely recipients — Pittsburgh & Lake Erie and Guilford — possess such resources. Both operate small regional systems, already dependent to a considerable degree on Norfolk Southern and Conrail. Pittsburgh & Lake Erie and Guilford in combination in 1984 showed a $10 million net loss. As a practical matter, the long-term viability of neither Pittsburgh & Lake Erie or Guilford is assured. Certainly, neither is in a position to provide an effective alternative for major inter-regional shipments in competition with a Norfolk Southern-Conrail combination.

4. Reduction of Competition and Increased Prices Paid For Shippers and Consumers.

Without an appropriate cure for the problems created by the combination, competition will be restrained, and price and service competition will decline on commodities which cannot be diverted to highways or barges. The steel mill that now receives competing bids for contract freight rates from Conrail and Norfolk Southern could face higher prices overnight.

Using its monopoly power, including its exclusive access to numerous cities, power plants, mines, mills and other industries, a combined Norfolk Southern-Conrail could divert traffic from now-solvent but marginal railroads, triggering additonal bankruptcies, abandonment of facilities and loss of jobs. There is serious doubt, for example, as to whether the Baltimore & Ohio Railroad could survive in the face of such competition, especially for coal business moving to northeastern power plants.

To illustrate, in the existing market, Conrail does have market power with respect to rail traffic moving from Harrisburg to Chicago, but between Chicago and Kansas City a shipper has a choice of either Norfolk Southern, Santa Fe, Chicago & North Western, Illinois Central Gulf or Burlington Northern for the final segment of the route. Conrail presently has an incentive to direct Harrisburg traffic bound for Kansas City over these connections which is comparable to its incentives to direct such traffic over Norfolk Southern, providing the shipper with the benefits of price competition for the route segment between Chicago and Kansas City. After the proposed transaction, Conrail could make the short-haul Harrisburg-Chicago rate to its unaffiliated connections so prohibitively costly that no shipper could use that route even if the Chicago gateway remained open. This would effectively direct all former interchange traffic to Norfolk Southern. The Justice Department does not address the impact of such potential abuses of market power.

5. The Morgan Stanley Proposal Avoids These Competitive Problems.

The Morgan Stanley proposal provides for the preservation of an independent Conrail. Existing competition among Conrail, Norfolk Southern and other railroads would be maintained. This is in harmony with the underlying purpose of the Northeast Rail Service Act of 1981.

Under the Morgan Stanley proposal, Conrail will not be integrated into the financial structure or corporate operations of any of the investors. Divestiture of Conrail assets required for a combination with Norfolk Southern will not be necessary. By maintaining an independent Conrail, the Morgan Stanley proposal will preserve the status quo and avoid the serious, anti-competitive problems raised by the Norfolk Southern offer.

Appendix F.—Response to Shearson Lehman Brothers/Norfolk Southern Statements on Morgan Stanley Conrail Proposal

[Dated May 31, 1985]

The memoranda by Norfolk Southern and Shearson Lehman Brothers responding to the Morgan Stanley Conrail proposal indicate a lack of understanding of the Morgan Stanley proposal and, in many instances, simply misrepresent the facts in attempting to compare the two proposals. As one would anticipate, their responses focus on defending the Norfolk Southern offer and attack an independent, publicly-held Conrail—without regard to the business merits. Morgan Stanley would like to clarify any confusion created by these statements and to point out those areas where their analysis is flawed.

Proceeds to the Government. The Morgan Stanley proposal provides higher proceeds to the government than the Norfolk Southern offer despite their contention to the contrary. Both provide $1.2 billion in cash as well as for the surrender of tax carryforwards and "excess" Conrail cash. However, the Morgan Stanley proposal provides the following additional financial benefits:

Stock purchase warrants for 1 million shares of Conrail stock exercisable at $48 over a 10-year period, and

retention by the government of an estimated $600 million (present value) in tax revenues that would be lost to the federal government under the Norfolk Southern offer.

The stock purchase warrants offer the government the opportunity to participate in any appreciation of Conrail's stock price from the $48 purchase price—at no risk and no cost to the government. Moreover, the government will be able to benefit from any share price appreciation, at its option, at any time following a public offering, in the 10-year term of the warrants.

Although Shearson tries to downplay the value of these warrants, it does concede that they would have a minimum value of $24 million, based on a 20% appreciation of Conrail stock. However, in its effort to compare this no-risk additional gain to the government with the potential return to the investor group, Shearson fails to mention several critical points. First, even though the market price of Conrail may have risen 20%, the investors may not be in a position to realize much of their paper profit, because market conditions may not permit them to sell a significant part of their holdings. Second, to the extent investors actually realize gains, the investor group will pay taxes to the government, which will lower their returns and at the same time increase the government's return (permitting the government to participate further in Conrail's upside potential). Third, the investors undertake all the market risk—precisely that risk that the government has indicated it did not want to take. In short, it appears irrefutable that a 10-year warrant provides real value, carries no risk, and should be seen as valid and meaningful additional proceeds to the government.

Shearson and Norfolk Southern agree with Morgan Stanley that there will be tax costs to the government from the Norfolk Southern plan. They then try to downplay the amount of these costs. Interestingly, the $100 million figure they now cite contrasts with prior statements that tax losses would be insignificant.

To date Norfolk has refused to make public forecasts of future earnings for itself and Conrail, which is important for determining the estimated tax losses. Shearson's and Norfolk's contention that such projections are required by SEC rules to remain confidential is simply wrong. Morgan Stanley's legal advisors have clearly indicated that the SEC allows the release of earnings forecasts under certain guidelines. Morgan Stanley, with the assistance of outside tax experts, has made a good faith effort to estimate the lost tax revenues that will result from the Norfolk Southern offer. However, when Norfolk Southern releases its projections, the full extent of such tax revenue losses will become apparent.

Treatment of Conrail Employees. Shearson and Norfolk contend that the Morgan Stanley proposal is "weaker" than the Norfolk Southern offer in its treatment of Conrail employees. Again, their analysis is not supported by the facts.

By focusing entirely on cash payments, Shearson unfairly ignores the value of the 15% of Conrail stock which would be retained in the existing Employee Stock Ownership Plan (ESOP) under the Morgan Stanley proposal. For comparison to the Norfolk Southern offer, Morgan Stanley has valued these shares at $210 million—based on the same $48 per share price to be paid to the government. Should the Conrail stock be trading in the public market at a price in line with the other major railroads, the value of the 4.4 million shares held in the ESOP could be significantly above this valuation.

Shearson credits Norfolk Southern for offering New York Dock labor protections to employees who lose their jobs as a result of a Norfolk Southern-Conrail combination, yet fails to recognize that such protections are routinely required by the ICC in railroad merger cases. Because the Morgan Stanley proposal will maintain Conrail as an independent entity and will not cause the displacement of employees that would result from a Norfolk Southern-Conrail combination, the labor protection requirements will reflect these different circumstances.

Shearson criticizes the use of the term "force-out" to describe Norfolk Southern's ESOP proposal but does not dispute Norfolk Southern's intention to terminate the current Conrail ESOP—reportedly for the equivalent of $17 per share or less than half the value paid to the government. By contrast, the Morgan Stanley proposal offers Conrail ESOP beneficiaries the choice to hold all their shares or sell a portion for cash at the $48 price.

Shearson totally fails to mention that the Morgan Stanley proposal guarantees employees two representatives on the Conrail Board of Directors—the same number as are reserved for management.

Ultimately, however, the real test of fairness between the two proposals will be demonstrated by the level of support given by Conrail employees and the beneficial owners of the ESOP.

Total Investor Payment. Shearson and Norfolk Southern allege that the Morgan Stanley investor group will pay significantly less for Conrail than Norfolk Southern. This conclusion is clearly wrong and seriously misrepresents elements of both the Norfolk Southern and the Morgan Stanley proposals.

Shearson and Norfolk overlook the fact that while Norfolk Southern would acquire 100% of Conrail, the Morgan Stanley investor group would only acquire 85%. This makes a significant difference in comparing the two proposals.

The Morgan Stanley proposal calls for $230 million of Conrail's cash to be used to pay agreement and non-agreement employees in settlement of prior wage claims. In addition, to the extent that there is Conrail cash available after giving effect to any excess cash payments to the government and providing for the maintenance of $500 million cash balances (as required under the covenants agreed to by Norfolk Southern and the DOT), the Morgan Stanley proposal contemplates that that cash may be used to purchase shares held by ESOP beneficiaries at the option of such individuals.

Neither the investors as a group nor any single investor will have Conrail cash balances available for its own use.

In contrast, Norfolk Southern, which is buying 100% of Conrail, will acquire at the closing all of Conrail's cash up to $800 million and will be able to use all that cash in operating the combined business, including making payments to Conrail employees and beneficiaries of the ESOP, repaying the bank loans, purchasing equipment and financing working capital. In fact, if Norfolk Southern chooses not to have Conrail pay dividends, Conrail will never have to have a $500 million cash balance at all. It could simply upstream loans for the five-year period in which the public interest covenants are in effect.

Instead of pointing this out, however, Shearson implies that the entire $375 million in planned payments to Conrail employees for stock and prior claims under its offer will be derived from Norfolk Southern funds. This is clearly inconsistent with Section 12(b)(v) of the Memorandum of Intent between Norfolk Southern and the DOT, which specifically contemplates the use of Conrail cash to settle non-ESOP employee claims. Shearson's portrayal of the $375 million as Norfolk Southern funds is extremely misleading.

Shearson's and Norfolk's analysis of dividend policy under the Morgan Stanley proposal overlooks Morgan Stanley's projections of the dividends and as a consequence misrepresents the Morgan Stanley proposal. Shearson contends that the Morgan Stanley proposal would permit dividends to be paid on Conrail earnings prior to closing. This mischaracterizes the intent of the Morgan Stanley proposal and willfully ignores the pro forma Conrail income and dividend projections prepared by Morgan Stanley, which clearly show an annual dividend objective of approximately $121 million. Anticipating the possibility that variations in earnings based on seasonal or other factors could artificially constrain the payment of dividends during the first or second quarters subsequent to closing under the dividend covenants imposed by the DOT, Morgan Stanley has proposed to begin the cumulation period six months prior to closing. Although not important to a company controlled by a single shareholder which can take dividends at its leisure (or not take them at all) or shift earnings among units in the corporate group, the ability for a board of directors to exercise its prerogative to determine appropriate dividend policy is critical to a publicly-held company. The Morgan Stanley investor group has

no intention to use this flexibility to authorize an immediate $72 million dividend as suggested in Shearson's analysis and is prepared to work with the Congress and the DOT to develop appropriate safeguards to prevent such a result.

Public Interest Covenants. Shearson and Norfolk contend that the Morgan Stanley proposal fails to meet several of the covenants imposed by the DOT. Again, Shearson's analysis is seriously misleading.

Shearson faults the Morgan Stanley proposal for failing to require the investor group to make additional investments should Conrail meet economic difficulties. It states that "Norfolk Southern clearly will contribute any needed incremental capital." This seriously misrepresents the extent of Norfolk Southern's commitment to Conrail under the covenants contained in the Memorandum of Intent. These covenants do not require Norfolk Southern to invest an additional dollar in Conrail. Norfolk Southern has *not* promised to subsidize Conrail. Norfolk and Western's own history of permitting the failure of its economically-troubled Delaware & Hudson and Erie-Lackawanna subsidiaries in the early and mid-1970's stands in sharp contrast to Norfolk's purported "commitment."

Shearson also faults the Morgan Stanley proposal for failing to require the refund of previously paid dividends should Conrail be unable to meet the $350 million annual cumulative capital expenditure requirement. This argument fails to recognize the obvious impossiblity of requiring refunds of dividends paid to public stockholders including ESOP holders by a widely-held, publicly traded Conrail. By conditioning the payment of future dividends on satisfactory compliance with capital spending requirements, the Morgan Stanley proposal would accomplish the same essential purpose.

Finally, Shearson faults Morgan Stanley for urging the Congress to consider carefully whether some of the covenants developed by the DOT in contemplation of a sale to a single corporate purchaser may be appropriate when applied to a publicly-held Conrail. Morgan Stanley has publicly stated its willingness to accept the covenants on essentially the same basis as Norfolk Southern. Clearly, the issue of whether the covenants should apply to an independent publicly-held Conrail is a legitimate one and deserves full and careful consideration by Congress, as no other publicly-held railroad has such covenants.

Economic Viability. Nothing in Shearson's or Norfolk Southern's analyses suggests that an independent Conrail is not economically or financially viable. Rather, criticism is focused on the structure of the proposal and the fact that Morgan Stanley updated one-year old forecasts for Conrail.

In particular, Shearson compares dividend and capital expenditure projections under the Morgan Stanley proposal to those of the USRA, but without disclosing that the USRA data are based on Conrail operating projections and economic assumptions which are a year old. For example, the assumption of a recession beginning in 1986, which underlies Conrail's projections and, in turn, the USRA data, is no longer held by most leading economic forecasters, including those preparing the Administration's own forecast. Morgan Stanley's 1985 revision of the 1984 forecasts reflects this revised economic outlook. Shearson also fails to disclose that even on the basis of the pessimistic 1984 economic forecast, USRA has predicted "modest but solid profits for Conrail" over the next four years.

Furthermore, Morgan Stanley believes that new USRA figures, to be developed from updated Conrail projections, will take into account, as they should, the current outlook for the economy.

Shearson further asserts that the Morgan Stanley projections for capital expenditures fall $281 million short of the USRA projections in 1988 (prepared by Conrail Management in mid-1984). This is not relevant to determining whether or not Conrail can meet the capital expenditure covenant and further implies that Conrail under the Morgan Stanley proposal will invest less in capital equipment than Norfolk Southern. In fact, Morgan Stanley's $500 million annual capital spending projections are exactly the same as those agreed to by Norfolk Southern with the DOT in its Memorandum of Intent.

Commitment of the Investor Group. Shearson and Norfolk Southern question the commitment of the Morgan Stanley investor group to assuring the long term economic viability of a publicly-held Conrail. Again, their analysis is erroneous.

Investors in the Morgan Stanley group, ESOP shareholders and future public shareholders will be just as committed to the ongoing viability of Conrail as are the current public shareholders of Norfolk Southern.

In fact, both the Morgan Stanley and Norfolk Southern proposals offer the same commitment to maintain Conrail as a going concern.

It is simply distorting to suggest, as does Norfolk Southern, that the Morgan Stanley proposal is a "blueprint for cannibalization" and dismemberment of Conrail. In

truth, at the end of the five-year covenant period, it is Norfolk Southern that will be in a better position to dismantle Conrail under the Norfolk Southern proposal—not a public shareholder under the Morgan Stanley proposal and particularly not CSX, which may not even be a shareholder at that time. Why? Because Norfolk Southern will own 100% of Conrail and will control decisions on any disposition of Conrail. Under the Morgan Stanley proposal no public shareholder will own more than 10%, no shareholder seeking to take control of Conrail will have any advantage over another, and any shareholder seeking control will have to pay an acquisition premium and be subject to ICC and other regulatory review. Clearly, a future dismantling of Conrail under the public offering alternative will be exceedingly difficult and subject to full public scrutiny.

The characterization of CSX participation in the Morgan Stanley investor group also is seriously misstated and grossly unfair. In a publicly-held Conrail, CSX will have no advantage over Norfolk Southern or any other railroad that chooses to take a position in the stock of a publicly-held Conrail. In fact, CSX's holding will be subject to the most stringent conditions. CSX has agreed that its shares will be held in a voting trust meeting ICC guidelines and in compliance with the proportionate voting requirements of Section 401(d) of the Regional Rail Reorganization Act of 1973. These restrictions will apply to CSX as long as it holds Conrail stock. In addition, CSX will not participate in management, will not have a representative on the Conrail Board and will not participate in the Executive or the Finance Committee of the investor group. Therefore, in no way will CSX have the ability to influence the management of an independent Conrail. It is preposterous to suggest, as do Shearson and Norfolk Southern, that CSX would be in a position to achieve a breakup of Conrail after five years.

CONCLUSION

The Morgan Stanley investor group remains firmly committed to the proposal which was announced on May 14. Morgan Stanley continues to believe that its proposal offers the government a substantially superior financial return in comparison to the Norfolk Southern offer when tax and other consequences, including the offer of a million stock purchase warrants, are considered.

The Morgan Stanley group welcomes detailed scrutiny of its proposal by the Congress and the public over the coming weeks and remains confident that based on that scrutiny, its proposal will be judged superior to the Norfolk Southern offer.

Appendix G

June 7, 1985

SUMMARY OF CHANGES IN DRAFT AGREEMENTS

The following sets forth changes made in the agreements (drafts of May 14, 1985) relating to the proposed Conrail transaction, and the reasons for such changes.

I. Shareholders Agreement (Tab A)

1. Page 5 - Section 2.04: add a new subparagraph (c) as follows:

(c) During the period prior to 5 years from the Closing Date, no Shareholder shall acquire by any means common stock of Conrail (whether DOT Stock or otherwise) so as to increase its holdings to in excess of 10% of the then outstanding shares of common stock of Conrail. In addition, any Shareholder (together with its Affiliates) who acquires on the Closing Date more than 10% of the then outstanding shares of common stock of Conrail will not be permitted to add to its holdings, whether by purchases in the open market or from other Shareholders pursuant to Section 2.05, until such time as its holdings are reduced below 10% of the then outstanding shares of common stock of Conrail, after which time the first sentence of this paragraph shall become applicable.

The change spells out what was originally intended, that no Shareholder holding more than 10% of the outstanding shares of Conrail at the Closing Date will be allowed to increase its holdings during the time that the Shareholders are exempted from the statutory prohibition on holdings of 10% or more, but must "sell down" to a lower than 10% holding during that period.

2. Page 6 - Section 2.10, third line - change "may" to "shall".

The change is to make it clear that Railroad Purchasers (as defined) will have to place their DOT Stock and any other Conrail stock in a statutory voting trust.

3. Page 15 - Section 4.04, final sentence - Change sentence to read as follows: "Persons representing Railroad Purchasers shall not be eligible for election to the Finance Committee."

The change makes it clear that Railroad Purchasers will not serve on the Finance Committee.

4. Page 16 - Section 4.09, last sentence - add after "Executive Committee" the following: "or the Finance Committee".

The change reinforces the prohibition on Railroad Purchasers serving on the Finance Committee by requiring that their stock not be voted for Finance Committee members unless it has been placed in a statutory voting trust.

5. Page 20 - Section 6.02 - Revise to read as follows:

SECTION 6.02. Amendments and Waivers. Any provision of this Agreement may be amended, or a requirement hereof waived, if, but only if, such amendment or waiver is in writing and is signed by Conrail, the Agent, and the holders of a majority of the DOT Stock at the time still in the hands of the Shareholders, provided, however, that Sections 2.04, 2.10, 4.01, 4.02, 4.04 and 4.09 may not be amended without the written consent of the DOT.

The addition gives the DOT the power to prevent certain amendments to the Shareholders Agreement, and thus reinforces the covenant of the Purchasers to the DOT found in Section 7(a) of the Purchase Agreement (see errata no. 8 below).

6. Schedule 3 - Add a new subsection A, as follows:

A. Termination

When the Agent shall become aware, either by notice by or on behalf of Conrail or from its own records or otherwise, that the conditions set forth in Section 2.04(b) of the Shareholders Agreement have been met, the Agent shall send written notice to Conrail and to every Shareholder pursuant to Section 6.01 -- and to the DOT at Department of Transportation, Washington, D.C. 20549, Attention: The Secretary -- to indicate that the conditions in Section 2.04(b) have been satisfied, and to specify a date no later than 30 days from the date of such notice on which the Shareholders Agreement shall terminate. The Shareholder Agreement shall terminate, except for those provisions that purport to last for a longer period (such as Section 2.04(c) and Section 3.01), on the date set forth in such notice, and upon payment of all fees and satisfaction of all other obligations then owing under the Shareholders Agreement, the Shareholders, the Agent and Conrail shall be released therefrom.

The addition sets forth termination procedures.

II. Purchase Agreement (Tab B)

7. Page 6 - Section 5(d)(ii) - remove the proviso.

The removal clarifies the original understanding that the Purchasers are not requiring a "warranty of basis", directly or indirectly, from the Government in connection with the transaction.

8. Page 8 - Section 7(a) - Revise to read as follows:

(a) sell or dispose of DOT Stock in amounts so as to comply with the restrictions of Section 2.04 of the Shareholders Agreement and will comply with Sections 2.10, 4.01, 4.02, 4.04 and 4.09 of the Shareholders Agreement, and

The change is designed to reassure the DOT that certain important features of the Shareholders Agreement are subject to its review.

III. Conrail Agreement (Tab C)

9. Page 9 - Section 3.01(j) - change opening phrases to the following:

(j) Compliance Certificate. Within forty-five (45) days after the close of each fiscal quarter of Conrail and promptly following the declaration of any common or preferred stock payment described in Section 3.02(e) by the Board of Directors of Conrail, but not later than 10 days before making any such payment, Conrail shall deliver to DOT a certificate. . . .

The change removes the need for a certificate 45 days in advance of a dividend payment, which is unrealistic when the Board is independent, but still requires that a certificate be given well before the payment of any such dividend, so that the DOT will have adequate notice of the intention to make such payment.

10. Page 11 and 12 - Section 3.02(e)(i) - remove the parenthesis from subparagraph B and add a new paragraph at the end of subparagraph (i) as follows:

Solely for purposes of the calculations under paragraph (2) of this subsection 3.01(e)(i), the following shall not be considered to be Common Stock Payments: (i) the purchase by Conrail of the Warrants from the DOT, (ii) purchases of up to 1,000,000 shares of common stock in response to, or in anticipation of, the exercise of the Warrants or (iii) purchases, directly or indirectly, of shares of common stock held as of the Closing Date by the Conrail ESOP pursuant to the arrangements referred to in Section 5(b) of the Purchase Agreements.

The amendment makes it clear that the specified excepted purchases are only exceptions from the 40% test of the dividend covenant, not the other provisions of that covenant. This means, for example, that the $500 million test must be met for any of the excepted purchases to be made.

11. Page 12 - Section 3.02(e)(i)(2) - Revise to read as follows:

(2) Immediately after giving effect to such Common Stock Payment, the cumulative amount of all Common Stock Payments made subsequent to the Closing Date shall not exceed (x) 40% of the Cumulative Net Income of Conrail accrued subsequent to the Closing Date minus (y) the cumulative amount of all Preferred Stock Payments (as defined herein) made subsequent to the Closing Date; provided, however, that the Board of Directors of Conrail may waive the limitation contained in this subparagraph (2) for the purpose of permitting payment of regular quarterly dividends on the common stock not to exceed $1.25 per share during each of the two quarterly periods commencing immediately subsequent to the Closing Date.

The revision makes it clear that the cumulation of Conrail net income for purposes of calculating common stock dividends will commence on the Closing Date. This eliminates the possibility of a dividend out of "pre-closing" earnings to the investor group. However, the provision authorizes Conrail's Board of Directors to waive the 40 percent limitation (up to $1.25 per share) for the first two quarters immediately following the closing, in order to permit the payment of regular quarterly dividends in the event of normal seasonal or other cyclical variations in Conrail income. The provision would automatically self-adjust in the third quarter when cumulative dividends could not exceed 40 percent of cumulative net income. Total dividends for the first year of independent operation, therefore, would be subject to the same limitation as that provided in the Norfolk Southern Memorandum of Intent.

12. Page 23 - Section 7.02 - Revise to read as follows:

SECTION 7.02 Survival of Covenants; Successors and Assigns. The covenants set forth in Section 3.01 and Section 3.02 shall survive for the periods indicated in such Sections. All other covenants, agreements, representations and warranties made by Conrail in this Agreement, and in certificates or other documents delivered pursuant hereto, shall be enforceable by and inure to the benefit of the DOT and its successors and assigns, and shall continue in full force and effect (according to the respective terms thereof) for so long as any of the DOT Stock continues to be held by any Purchaser. Conrail may not assign or otherwise transfer any of its rights or obligations under this Agreement.

The change is designed to make it clear that the covenants in Section 3.01 and 3.02 survive for the full five years indicated in those Sections, while all other covenants, agreements and representations survive as long as the DOT Stock continues to be held by any Purchaser.

[The following information was subsequently received for the record:]

QUESTIONS OF THE MAJORITY AND THE ANSWERS

Question. Why is Morgan Stanley not offering the Federal Government more than $1.2 billion?

Answer. The Morgan Stanley group is offering more than $1.2 billion. In addition to the $1.2 billion in cash (plus "excess cash"), the Morgan Stanley plan offers the government:

stock purchase warrants for one million shares of Conrail stock exercisable at $48 per share over a 10 year term; and

significantly higher tax revenues when compared to the Norfolk Southern offer

We believe that, together with the cash payments, these two benefits provide a much superior financial return to the government compared to the Norfolk Southern offer and a fair return based on the underlying value of Conrail. We base this conclusion on several factors:

The Department of Transportation, with the assistance of its financial advisor, Goldman Sachs, actively solicited proposals for the purchase of the government's interest in Conrail from a number of sources in late 1983 and 1984. The bid of each of the three finalists, including Norfolk Southern, was for $1.2 billion.

The application of a price/earnings ratio similar to those of other railroads comparable to Conrail to Conrail's projected 1985 earnings produces an estimated market value in the hands of the public of $2 billion for 100% of the company. The value of 85% of the stock would therefore be about $1.7 billion. This value must be discounted to reflect the significant risks borne by the investors, both the risk inherent with a company with cyclical earnings, such as a railroad, and the risk associated with changing market conditions. An additional discount will be needed to attract the public interest necessary to market the stock broadly. It is our professional opinion that $1.2 billion is an appropriate purchase price to take account for such risks and for the discount necessary to the marketing process.

As set forth in my letter dated July 1, for its $1.2 billion, Norfolk Southern will acquire 100% of Conrail and have total business and operating control. The investor group, however, will, in effect, make an interim equity investment for 85% of Conrail, leaving ESOP beneficiaries with an important 15% minority interest. As a group and individually, the investors will not exercise any control over Conrail.

Norfolk Southern will acquire full control without paying an acquisition premium, as would normally be the case in today's market. In fact, it is the Morgan Stanley group that is making a premium offer: the aggregate of $1.2 billion in cash, plus "excess cash", warrants, tax savings to the government, and tax revenues resulting from investor gains.

Since Norfolk Southern will control Conrail, it will own all of Conrail's cash balance of at least $800 million at the time of closing, cash that can be used by the entire Norfolk Southern group.

Question. What happened to the idea you testified to in February of having the Government share in any proceeds above $1.2 billion generated by the reoffering of stock to the public?

Wouldn't such an idea give the Government more cash than the purchase warrants you are now proposing?

Answer. Our proposal for Conrail to issue to the government warrants to purchase one million Conrail shares gives taxpayers a share in any future appreciation of Conrail stock. The stock purchase warrants offer the government the opportunity to participate in any appreciation of Conrail's stock price from the $48 purchase price, at no risk and no cost to the government. Moreover, the government will be able to benefit from any share price appreciation, at its option, at any time following a public offering during the 10 year term of the warrants.

Although others have tried to downplay the value of these warrants, they do concede that they would have a minimum value of $24 million, based on a 20% appreciation of Conrail stock. However, in their effort to compare this no-risk additional gain to the government with the potential return to the investor group, they fail to mention several critical points. First, even though the market price of Conrail may have risen 20%, the investors may not be in a position to realize much of their paper profit, because market conditions may not permit them to sell a significant part of their holdings. Second, to the extent investors actually realize gains, they will pay taxes to the government, which will lower their returns and at the same time increase the government's return (permitting the government to participate

further in Conrail's upside potential). Third, the investors undertake all the market risk, that very risk that the government has indicated it did not want to take. In short, the 10 year warrants provide real value, carry no risk, and are valid and meaningful additional proceeds to the government.

Question. Please describe Morgan's fee arrangements for handling the Conrail sale.

How much do you expect to earn?

Answer. Morgan Stanley has not yet negotiated its fee with the investors. A deferral of the fee negotiation is not unusual in transactions of this type in order to give all parties the opportunity to assess the value of the investment banker's services in the full light of the time, effort, risks and other circumstances of the transaction bearing on their value.

However, to assist the Committee in understanding the parameters within which our fee will be established, it may be helpful to clarify several points. First, any compensation to Morgan Stanley is dependent on consummation of the proposed purchase; we are currently receiving no compensation for our services or reimbursement of our expenses. Second, any compensation received by Morgan Stanley will be paid by the investors, not by the federal government. Third, our total compensation would probably involve several fees, including a fee for managing one or more public offerings of Conrail stock by the investor group. Such fees depend on the size of the offering, the breadth of distribution sought, the risks involved in the marketplace at the time, and other factors. Additionally, Morgan Stanley may be separately compensated for its efforts in developing the public sale proposal, organizing the investor group, negotiating with railway labor and supporting the proposal through the legislative process. Finally, we may realize a gain on our own proposed $50 million investment in Conrail stock, although this is not a fee and is subject to the risks of cyclical of performance and changing market conditions we have described in our answer to Question 1.

Because of the unusual nature of this transaction, the form and amount of appropriate compensation for services provided by Morgan Stanley will require extensive discussion and negotiation with the investor group. The compensation may involve a fixed payment, a percentage of the return to the investors (again, subject to the risks noted above), some combination thereof or some other method of compensation not presently envisioned.

Question. For 1986, you are projecting that Conrail's revenues will be $294 million higher than Conrail projected last hear, and that its operating profits will be $277 million higher. What is the basis for your projections for 1986 and beyond?

Do you assume rate increases by Conrail, and, if so, how much?

Do you assume capital spending will be reduced below the levels Conrail projected last year, and, if so, by how much?

Answer. A new Conrail forecast, published in June, 1985 and provided to you on June 12, 1985 in my formal statement to the Committee, has superseded the projections to which you refer. We have thoroughly reviewed this new forecast and have adjusted it for the effects of the proposed transaction.[1]

Conrail's current five-year forecast assumes that railroad cost inflation will average 4% per annum in 1985–1989. Conrail's forecast assumes cost recovery of about 80% in freight rates. Its rates therefore decrease 1% in the 1985 recession and increase 3% per annum thereafter.

We would be pleased to visit with you and your staff to discuss the details of Conrail's forecast of its business, commodity by commodity, its freight rates, costs of operations, capital expenditure programs, and so forth.

Question. Do you assume there will be a recession at any time in the next five years?

Answer. Conrail's forecast does include a recession in 1985, with tonnage off 6% from 1984, and contemplates a modest increase from the 1985 level during the next four years.

Question. What happens if Conrail's actual revenues and profits are below our projections?

Will dividend payments be reduced?

Answer. As mentioned in my letter of July 1, our proposal provides for Conrail to be governed by an independent board of directors. The board will operate the company in a manner which will assure its long term financial integrity consistent with its responsibilities to Conrail shareholders, and in compliance with the covenants incorporated in the Conrail sale agreements, including restrictions on Conrail's au-

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[1] The exhibits have been retained in the Committee files.

thority to pay dividends. Thus, if earnings were to fall below the level now anticipated, the Board would be required to reduce dividends below the levels now projected; the dividends paid to shareholders would be at risk, not Conrail's long term health. (Please note that the suggested Conrail dividend policy is conservative when compared to that of Norfolk Southern.)

Question. Will capital spending be reduced?

Answer. Just as the board would review its dividend policy in light of a Reduced level of business, it would also review Conrail's capital expenditure needs in a similar light. Reduced traffic would lessen wear and tear on Conrail's plant and equipment.

Under our proposal, Conrail would have one of the most conservative capitalizations of any company in the United States (see Exhibit I), and we believe its equipment debt would be rated "AA" or better. Conrail thus would be able to raise substantial funds in the domestic and international debt and equity markets to finance its capital expenditure program without impairing its creditworthiness. Such financing would be on terms as advantageous as those of its competitors, including Norfolk Southern.

Question. Will Conrail have to borrow money?

Answer. Consistent with industry practice, Conrail expects to make use of long term financing in funding part of its capital expenditure program. Because of Conrail's tax status, it is likely that this financing will take the form of capitalized leases. Nevertheless, it is anticipated that Conrail's debt ratio will decrease over the five year period.

Question. Will the investor group increase its contribution to Conrail?

Answer. First, as set forth in my letter of July 1, the investors should be seen as a group of sophisticated persons who are providing an interim step in the transfer of Conrail to the public. In that regard, unlike Norfolk Southern, the investors will not have control over Conrail, and will, in fact, distribute a significant portion of their holdings to the general public as soon after the closing as market conditions permit.

As with any publicly held company, the board of directors and the shareholders may consider a number of financing options in the capital markets, including solicitation of additional capital contributions from the existing shareholders. Whether the investors or beneficiaries of the ESOP or any other shareholders would increase their investment is a question each person would have to decide individually at the time and under the circumstances when such opportunity occurs.

However, with broad access to institutional and individual investors, Conrail will have a "deeper pocket" for its future financing needs than if it were just obliged to rely on Norfolk Southern.

Question. Under your proposal, would any of the ownership restrictions or any other covenants apply after five years?

Answer. Yes, under the proposed Shareholders' Agreement, any initial investor which is itself a railroad would be required to maintain its Conrail shares in a voting trust indefinitely. In addition, our proposal would preserve indefinitely the existing statutory requirement that any railroad purchaser holding a minority interest in Conrail stock must vote its shares in the same proportion as all other shares are voted.

After five years, when Conrail would be owned by a broad group of public shareholders, it would also continue to be subject to the same ICC and SEC rules relating to stock ownership and control as any other railroad.

Question. Would any of the restrictions or covenants (other than those dealing with SEC registration) apply within the first five years, if all the stock were sold to the public?

Answer. Yes, under Article III of the proposed Conrail Agreement, as well as Section 404 of S. 1361, all of the public interest covenants would remain in effect for a five year period following the closing. This would be without regard to the identity of Conrail's stockholders.

Question. What is the basis for your estimate of 10,000 job losses if Norfolk Southern acquires Conrail?

Who prepared this estimate?

Please provide the Committee with a breakdown by railroad of the 10,000 job losses.

Answer. The initial estimate of job losses resulting from a Conrail/Norfolk Southern combination contained in the May 14 proposal was based on estimates made by affected railroad unions. Since that time we have attempted to corroborate this estimate based on information provided to the ICC by affected rail carriers on the effects of a Conrail/Norfolk Southern merger. Using the ICC information as well as the estimates of Norfolk Southern and CSX Corporation, we have been able inde-

pendently to estimate a total of more than 8,000 job losses. This does not include possible losses by any of the three major western roads, which could be considerable. Exhibit II (attached) lists those projected losses by individual railroads.

Question. Last year, Conrail management estimated for purposes of its Five-Year Outlook that it would eliminate approximately 1,500 jobs per year. Does your proposal assume the elimination of any jobs, and if so, how many?

Answer. Conrail's revised five year plan assumes a loss of 2,300 positions over a five year period, through increased productivity and other factors, which will occur regardless of whether Conrail is purchased by Norfolk Southern or remains independent. None of these job losses is included in the figures set forth in Exhibit II.

Question. Under your proposal, would any of these employees be entitled to labor protection?

Answer. Yes. Under the July 3, 1985 agreement among Conrail, Morgan Stanley and members of the RLEA Conrail task force (see Appendix A),[2] Conrail would maintain the schedule of labor protection benefits developed pursuant to Section 701 of the Regional Rail Reorganization Act, but responsibility for their funding would be transferred from the federal government to Conrail. The agreement also expands the eligibility criteria and increases the level of benefits to eligible employees. In addition, Conrail has agreed to become a signatory to the Washington Job Protection Agreement of 1936, which specifies labor protection benefits in the event of mergers or other coordinations of facilities between rail carriers. The agreement further provides that affected Conrail employees would also be eligible for labor protection imposed by the ICC in connection with ICC-regulated transactions involving Conrail.

Question. It has been reported that your discussions with rail labor broke off over specific issues. What issues caused the break off?

Answer. On July 3, as discussed above, Conrail, Morgan Stanley and members of the RLEA Conrail task force initialled an agreement under which members of the RLEA support the sale of the federal government's interest in Conrail to the Morgan Stanley investor group.

Question. You testified that under your proposal, Conrail would purchase stock held by the employees at the employees' option "to the extent there is some cash available." How much cash do you assume would be used for this purpose? What happens if more employees want to sell their stock than there is cash available for this purpose?

Answer. Under the July 3 agreement among Conrail, Morgan Stanley and members of the RLEA Conrail task force, the existing Conrail ESOP would be amended (i) to require the distribution of all stock in the accounts of employees who attain age 59½ and to terminated employees, and (ii) to permit the distribution of all or part of the stock in the accounts of other continuing employees, provided that the stock has been held in the ESOP for a minimum of two years (or such shorter period as may be provided by legislation).

Conrail will be obligated to purchase at $48 per share out of "available cash" any distributed stock which the distributees desire to sell. For this purpose, "available cash" means cash and cash equivalents in excess of $500 million after providing for deferred wage settlements with employees, projected labor protection expenses, the payment of "excess cash" to the government under the proposed Purchase Agreement, and projected requirements of the business. If the value of shares offered by the participants for purchase exceeds "available cash", Morgan Stanley has agreed to arrange for such additional purchasers as may be necessary to buy the remaining shares offered at $48 per share.

Question. Mr. Chapoton testified that you were preparing a new tax revenue estimate of the sale to Norfolk Southern using Conrail's revised Five-Year Outlook. Please provide this to the Committee.

Answer. The new tax revenue estimate is attached as Exhibit III.

Question. Assuming each year's earning and profits are less than the dividends paid during that year, what tax benefits would accrue to the investors as a result of the initial earnings and profits account of $500 million?

Answer. Under the proposed Conrail Agreement, Conrail would be prohibited from paying dividends on its common stock in excess of 40% of its net income for five years after the closing. Therefore, the balance of Conrail's earnings and profits (E&P) account is not likely to affect the tax treatment of dividends received by Conrail shareholders during that period.

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[2] Ibid.

After five years, Conrail's E&P balance could affect the tax treatment of stock dividends in several ways. Under the Internal Revenue Code of 1954, as amended, a distribution to shareholders with respect to their stock is treated as a dividend to the extent that the distribution corporation has current or accumulated earnings and profits for tax purposes. If a corporation has an accumulated deficit in its E&P account, but has E&P in its current taxable year at least equal to its distributions to shareholders with respect to their stock, the distributions are treated as dividends for tax purposes. Similarly, if a corporation has accumulated E&P and a current year deficit, but one which is smaller than accumulated E&P, a distribution to shareholders of an amount up to the difference between the two would be treated as a dividend for tax purposes.

Distributions to shareholders in excess of current and accumulated E&P are first treated as tax-free returns of capital, which reduce the shareholder's basis in his shares (thereby decreasing his loss or increasing his gain on the subsequent sale or exchange of the shares). After the recovery of all of the shareholder's basis in his shares, distributions in excess of current and accumulated E&P are generally taxed as capital gains.

Individuals and corporations have conflicting interests as shareholders as to whether they want distributions to be treated as dividends. A corporation generally includes in its taxable income only 15% of a dividend from another corporation, for an effective tax rate on such income of 6.9%. If it reduces its basis in the stock due to a "tax-free dividend" (return of capital), that amount may later be taxed at 28% if the stock is sold at a gain. In contrast, dividends are taxed to individuals as ordinary inome (after a $100 per taxpayer exclusion) at a top rate of 50%. If the distribution were instead treated as a"tax-free dividend" (return of capital), it would not be taxed currently and would later be taxed (if the stock were sold at a gain) at no more than a 20% rate.

In structuring the proposed purchase, Morgan Stanley therefore faced a dilemma of potentially creating differential tax treatment between individual and corporate shareholders. Morgan Stanley resolved the matter by proposing an initial E&P account of $500 million in order to have Conrail distributions treated like the distributions in respect of common stock of any other Fortune 500 Company. The dividends of IBM or General Motors, for example, are treated as ordinary income for tax purposes. We believe a publicly owned Conrail should be treated the same.

Questions of Senator Gorton and the Answers

Question. Please respond to the argument that a stand-alone Conrail will not have the long-term financial stability of a Conrail affiliated with a larger rail network.

Answer. The $1.2 billion cash commitment from the investor group is the strongest testimony to the financial stability of a stand-alone Conrail and to its future as a major independent rail carrier.

The investors in the group have independently concluded, based on considerable experience in investing in railroads, that Conrail is viable for the long term. Indeed, several testified to this effect at the hearings. Long-term viability is key to these investors because: 1) they are making a commitment to invest in Conrail for up to five years; 2) they are giving discretion as to the future disposition of their shares to the Finance Committee of the shareholders' group; and 3) they will bear the responsibility for and the market risk of transferring the Conrail stock to the public.

Just as with the investors, the long-term interests of labor are best served by a viable Conrail. Labor's endorsement and support of the Morgan Stanley proposal is further confirmation of Conrail's viability.

Other facts bear out our confidence in Conrail's future as an independent railroad:

Other facts bear out our confidence in Conrail's future as an independent railroad:

Changed Environment. The Staggers Act of 1980 and Northeast Rail Service Act of 1981 totally changed Conrail's operating environment by allowing the railroads to manage according to the changing needs of the marketplace and on a for-profit basis.

Unparalleled Turnaround. Conrail, because of its able management and cooperative labor groups, has achieved a financial turnaround unparalleled in railroad history. Even though tonnage declined 28% from 1977 to 1984, and despite the prolonged 1980–82 recession, Conrail recorded a financial turnaround of over $900 million, from a 1977 net loss of over $412 million to 1984 profit of $500 million.

Strong Performance in 1984. In terms of improvement in operating efficiency and net railway operating income, Conrail outperformed many other railroads' during 1984. In a 1984 survey of shippers, conducted by Distribution Magazine, Conrail was voted the best railroad in the country in service, pricing and communication.

Superior First Half Performance. The first half performance in 1985 demonstrates Conrail's ability to withstand sudden cyclical economic downturns. Although carloads abruptly decined in this period, Conrail's ability to control costs allowed it to perform well and even to outperform its competitors in many ways. (See Exhibit I.) [1]

Low Cost Producer. Conrail is the low cost producer of merchandise freight service in the northeast and midwest, largely because of its strong market position, lower train operating costs, modern plant and equipment, labor support and management.

Viability Forecast. Conrail's 1985-1989 projections support the case that Conrail will be viable as a publicly held company under the investor group proposal.

Strong Balance Sheet. The Morgan Stanley proposal results in a balance sheet that establishes Conrail as having one of the strongest capitalizations in the industry.

Viability and Growth Potential. Not only is Conrail viable as an independent enterprise, if business volume grows and new services are offered, Conrail is preceived to have attractive earnings potential.

There is no inherent reason Conrail as a subsidiary of Norfolk Southern should be a better performer than as an independent company. It has been argued, however, that, in the event Conrail experiences reverses, Norfolk Southern will contribute capital to finance losses by the railroad, yet Norfolk Southern is not committed legally to support its investment in Conrail with additional funds; there is no covenant to this effect in Norfolk Southern's proposal. Norfolk Southern's own history of permitting the failure of its economically troubled Delaware and Hudson and Erie Lackawanna railroads in the early and mid-1970s contrasts sharply with any expectations that Congress may have for a "deep pocket" commitment from Norfolk Southern for Conrail.

Furthermore, Norfolk Southern combined with Conrail would itself be a most attractive target and its business and capital structure could be drastically and adversely affected as the result of a takeover.

Question. You claim that "Because the [Morgan Stanley] proposal would preserve Conrail as an independent entity, it will avoid the job losses resulting from consolidations in the Norfolk Southern/Conrail system and job losses on other affected railroads. Job losses directly resulting from consolidation of Norfolk Southern/ Conrail operations have been estimated to be up to 10,000 on an industry-wide basis." (Sec. VI, p. 3, materials provided by my office). Who made this estimate? Please discuss how this conclusion was reached.

Answer. The initial estimate of job losses resulting from a Conrail/Norfolk Southern combination contained in the May 14 proposal was based on estimates made by affected railroad unions. Since that time, we have attempted to corroborate this estimate based on information provided to the ICC by affected rail carriers on the effects of a Conrail/Norfolk Southern merger. Using the ICC information as well as the estimates of Norfolk Southern and CSX Corporation, we have been able independently to estimate a total of more than 8,000 job losses. This does not include possible losses by any of the three major western roads, which could be considerable. Exhibit II (attached) lists those projected losses by individual railroads.

Question. Why do you believe that it would not be advisable for a publicly-held corporation to operate under the covenants agreed to by Norfolk Southern?

Answer. The covenants were originally designed to prevent misuse of Conrail's assets in contemplation of its private sale to a single corporate purchaser. They were not designed for a publicly owned independent Conrail. A corporate board of directors is under a legal duty to conduct the affairs of a corporation in a manner consistent with the best interests of the corporation and its stockholders, as would be the board of directors of an independent Conrail. In this context, placing Conrail's board under constraints is unnecessary to protect Conrail's integrity and could limit reasonable management discretion. Nevertheless, the Morgan Stanley proposal provides that Conrail will comply with the same or equivalent covenants proposed by the Department of Transportation for five years after the closing.

Furthermore, the efficacy of the covenants is different for an independent Conrail than for a Norfolk Southern-owned railroad. For example, if Norfolk Southern elects to have Conrail pay no dividends to Norfolk Southern, the $500 million mini-

[1] The exhibits have been retained in the Committee files.

mum cash balance covenant is meaningless. On the other hand, a publicly owned Conrail must pay its public shareholders dividends in line with industry practice, and so must meet the cash balance covenant.

Similarly, although Norfolk Southern must meet minimum cumulative capital spending at Conrail of $350 million per year, it can cause Conrail to acquire equipment (such as rolling stock or computer equipment) for use throughout the Norfolk Southern system. This is not so with an independent Conrail, which must devote all its capital spending to the Conrail system.

Question. Please compare the amount of money available to Conrail for capital improvements immediately following the closing of the Norfolk Southern deal and the Morgan Stanley deal.

Answer. We have set forth in Exhibit III the amounts of capital investments to be made under the Morgan Stanley proposal and the sources of their financing. The projections support the expectation that Conrail will be able to carry out its large capital expenditure program, pay common stock dividends, and, at the same time, maintain cash balances comfortably above the level required by the covenants.

It may be technically accurate to say that Norfolk Southern will use $375 million of its own cash when it acquires Conrail to settle prior wage claims of employees and purchase the ESOP interest, and that there will be $800 million in cash at Conrail "on the day of the closing". But it is not therefore true that Norfolk Southern will pay $375 million more for Conrail than will the investor group, so as to make this amount available, for example, for capital expenditures above the $350 million convenanted annual commitment. Although our proposal does contemplate that Conrail use $230 million of its cash for past wage settlements, the investors have no claim on or access to any of Conrail's cash. In contrast Norfolk Southern can use all of Conrail's cash balance of $800 million or more, including for reimbursing itself for $375 million payment, repaying bank loans, purchasing equipment, financing working capital and making intercompany loans and payments.

Question. Please compare, with specificity, the effect on rail freight competition of the Norfolk Southern offer and the Morgan Stanley offer.

Answer. A combination of the largest rail carriers in the Northeast and Midwest would substantially diminish competition in that region. The Department of Justice has analyzed the effect on competition of a Norfolk Southern/Conrail combination and conceded that such a combination would violate both the Clayton Act and the Interstate Commerce Act merger review standards in the absence of appropriate divestiture. It is interesting to note that, notwithstanding an intensive effort on the part of Norfolk Southern to negotiate with midwestern regional carriers, these same railroads have indicated repeatedly that their viability would be jeopardized by a Norfolk Southern/Conrail combination. They have further indicated that the Norfolk Southern proposal would have a destablilizing effect on the national railroad system and cannot be justified.

There is no evidence that the patchwork of divested lines and trackage rights proposed to be provided to small and marginally profitable regional carriers by Norfolk Southern addresses the fundamental and long term anti-competitive effects of the proposed combination. These effects would reach not only shippers but also, as indicated, regional connecting carriers, damaging rail freight competition in the Northeast and Midwest with residual effects throughout the nation.

Submissions to the Interstate Commerce Commission by other carriers and concerned shippers in connection with a Norfolk Southern/Conrail combination estimate the devastating effects on jobs and rail revenues of expected traffic diversions by a Norfolk Southern/Conrail combination. Some of these findings are summarized in Exhibit II.

Question. Do the persons making investments for Columbia and Princeton act in a fiduciary capacity? If so, what standards govern their investment decisions, and how did they decide that Conrail was a sound investment?

Answer. We assume that the persons making investments for Columbia and Princeton are acting in a fiduciary capacity. A number of the investors, including Princeton, T. Rowe Price (acting for the State of Delaware Board of Pensions) and Citicorp Capital Investors presented testimony precisely on point at the Committee hearings on June 12. This tetimony was especially revealing as to the financial analysis and methods by which these investors reached their decision to join the Morgan Stanley group.

QUESTIONS OF SENATOR HOLLINGS AND THE ANSWERS

Question. If Morgan Stanley's projections of Conrail's earnings are not realized during the period of ownership by the investor group, how will Conrail make the amount of capital expenditures required by the DOT covenants ($350 million per year) and still meet its obligation to pay the $121 million in annual dividends called for by the Morgan Stanley proposal? If you plan to fund the shortfall by reducing costs, please outline your plan? If you plan to fund the shortfall by borrowing or raising new capital, please explain your plan for accomplishing that?

Answer. Under the Morgan Stanley proposal, all expenditures forecasted under the management plan can be met by Conrail, including the capital expenditure projections (averaging about $650 million a year) contained in management's recently revised five-year outlook. It can be seen from our analysis entitled "Summary Projections—Conrail's Forecasted Performance," which is attached,[1] that Conrail will have healthy year-end cash balances in each of the next five years even after payment of dividends and making projected capital expenditures. The reasonableness of our forecast has been confirmed by the July 29, 1985 Staff report of the United States Railway Association which concludes that Conrail is viable as a stand-alone entity.

It should be pointed out that, under the Morgan Stanley proposal, if Conrail maintains only the minimum level of capital expenditures of $350 million a year required by the covenants, it is forecast that the company's cash balance at the end of five years will build up to almost $1.5 billion.

Consistent with industry practice, Conrail expects to make use of long-term financing. Because of Conrail's tax status, it is likely that this financing will take the form of capitalized leases. Under our proposal, Conrail would have one of the most conservative capitalizations of any company in the United States, with a capitalization containing only 16% debt, and we believe its equipment debt would be rated "AA" or better. Conrail thus would be able to raise substantial funds in the domestic and international debt and equity markets to finance its capital expenditure program without impairing its creditworthiness. Such financing would be on terms as advantageous as those of its competitors, including Norfolk Southern.

In the event of a downturn in Conrail's net income, the Board of Directors will make business judgments concerning operating expenses, dividends, capital expenditures, and borrowing. The Board will operate the Company in a manner which will assure its long term financial integrity consistent with its responsibilities to Conrail's shareholders, and in compliance with the covenants incorporated in the Conrail sale agreements, including restrictions on Conrail's authority to pay dividends. (Dividends are limited to 40% of net income and payable only if Conrail has cash balances of $500 million following payments.) Thus, if earnings were to fall below anticipated levels, the Board would be required to consider reducing dividends below the levels now projected.

Just as the Board would review its dividend policy in light of a reduced level of business, it would also review Conrail's capital spending in a similar light, since reduced traffic would lessen wear and tear on Conrail's plant and equipment. The public interest covenants established by the DOT require Conrail to spend each year the greater of annual depreciation or $500 million for capital expenditures. Capital expenditures may be reduced, in the Board's discretion, but in any event must total $350 million per year.

Question. USRA projections show Conrail with a positive cash flow of $17 million in 1986 without payment of any dividends. If dividends at the level of $121 million per year are paid, as the Morgan Stanley proposal calls for, Conrail would accumulate a cash deficit of over $250 million over the three year period 1986–88. How would this cash deficit be funded? Would Conrail incur added debt, or would capital expenditures be significantly cut back?

Answer. A new Conrail forecast, published in June, 1985 and provided to you on June 12, 1985 in my formal statement to the Committee, has superseded the projection to which you refer. As you know, the USRA published a new report on July 29, 1985, concerning Conrail's viability; this report includes the new Conrail forecast and states exclusively that Conrail is viable as an independent entity.

Please refer to the analysis entitled "Summary Projections—Conrail's Forecasted Performance," as well as the answer to Question No. 1 above for the detail underlying Conrail's anticipated use of long-term financing.

Question. Will the investor group increase its equity contribution if Conrail gets in financial trouble? Can Conrail's management make a call on these investors for

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[1] The attachments have been retained in the Committee files.

additional funds? If not, what will be the source for necessary additional funds? What will happen if some of the investors wish to invest additional funds and others do not?

Answer. First, the investors should be seen as a group of sophisticated persons who are providing an interim step in the transfer of Conrail to the public. In that regard, unlike Norfolk Southern, the investors will not have control over Conrail, and will, in fact, distribute a significant portion of their holdings to the general public as soon after the closing as market conditions permit.

As with any publicly held company, the Board of Directors and the shareholders may consider a number of financing options in the capital markets, including solicitation of additional capital contributions from the existing shareholders.

Whether the investors or beneficiaries of the ESOP or any other shareholders would increase their investment is a question each person would have to decide individually at the time and under the circumstances when such opportunity occurs.

However, with broad access to the U.S. capital markets including institutional and individual investors, Conrail will have a "deeper pocket" for its future financing needs than if it were obliged to rely solely on Norfolk Southern. These are the same capital markets that Norfolk Southern and all other major railroads use as the principal source of their long-term financing.

Question. If Conrail is performing below projections in the first year after closing, is there anything that prevents the investor group from dumping all its stock on the market and taking a short-term loss? Isn't there a potential tax write-off in such a short-term loss? What would prevent persons who may want to liquidate Conrail from buying this stock?

Answer. It would appear that the premise underlying this question is faulty in that it presumes (a) a group of knowledgeable investors would act precipitously in light of a near-term short fall in Conrail's performance and (b) any such sale would necessarily be at a loss.

There is no contractual commitment embodied in the Morgan Stanley proposal that prevents the investor group from selling all of its shares promptly after a closing with the U.S. government. However, several factors should be kept in mind: First—none of the investors will be able to act unilaterally, for the proposed shareholders' agreement requires that they relinquish discretion as to the timing and amount of any stock sales to a Finance Committee chosen by the investor group. Second—a number of investors, in responding to inquiries from Senator Danforth, have indicated their intention to invest for the long term in Conrail (to the extent not limited by the conditions imposed by the proposed shareholders' agreement). Thus, it is anticipated they are not likely to sell all of their shares in a precipitous manner. Finally—the investor group members seek to make a gain on their investment in Conrail in order to be compensated for taking on the entire market and economic risks associated with the transaction. Thus, their selling of their entire investment at a loss would not be consistent with their purpose even if, in the case of those investors who are taxpayers, such loss were mitigated in part by a reduction in tax liability.

As to the purchase of shares from the investors by an entity wishing to liquidate Conrail, the Morgan Stanley proposal contains a provision that, for five years after the closing, any person or group of persons acting in concert will be prevented from owning more than 10% of Conrail shares, and will thus be unable to liquidate the company or dismember it in any way. In addition, the Convenants applicable to the Morgan Stanley proposal provide that for five years, Conrail must be operated basically as it is today and, thus, can not be liquidated.

It should be pointed out that, under its proposal, Norfolk Southern has a much greater opportunity to dismember Conrail, for at the end of five years, Norfolk Southern will own 100% of Conrail and will control all decisions on the disposition of Conrail and its assets.

Question. Under the Morgan Stanley proposal, will the investor group use any of Conrail's cash to finance the payments it will be obligated to make to labor? If so, will not the withdrawal of these funds from Conrail's treasury further weaken the railroad and increase the likelihood that it will require a subsequent equity transfusion?

Answer. It is true that the Morgan Stanley proposal would require Conrail to pay employees approximately $230 million in recognition of past wage concessions. This payment recognizes the important contribution made by Conrail's employees to return the company to profitability. It seems to us that using Conrail cash in this manner is entirely appropriate since it is Conrail repaying its employees for past wage concessions. Looking to the investors, or any other shareholders of Conrail, to

repay the wage concessions would, in our view, be highly unusual and without precedent for a publicly owned company.

Although Norfolk Southern has "committed" to make a comparable payment from its own cash, this distinction is meaningless since Norfolk Southern's and Conrail's cash would be effectively commingled if Conrail were to become a wholly-owned subsidiary of Norfolk Southern. Since Norfolk Southern will control Conrail, it will own all of of Conrail's cash balance of at least $800 million at the time of closing. There should be no doubt on anyone's part that this cash can be used by the entire Norfolk Southern group. It may be technically accurate to say that Norfolk Southern plans to use $375 million of its own cash to settle prior wage claims of employees and purchase the ESOP interest and that there will be $800 million in cash at Conrail "on the day of the closing." But it is misleading to conclude that Norfolk Southern will pay $375 million more for Conrail than the investor group. Although our proposal does contemplate that Conrail use $230 million of its cash for past wage settlements, the investors have no further claim or access to any of Conrail's cash. In contrast, Norfolk Southern can freely use all of Conrail's cash balance of $800 million or more, including reimbursing itself for the $375 million payment, repaying bank loans, purchasing equipment, financing working capital and making other intercompany loans and payments.

Norfolk Southern would not have to declare a dividend to have effective access to Conrail's cash. The covenants to which Norfolk Southern has agreed would not prevent the "upstreaming" of Conrail cash to its new parent by its making loans to Norfolk Southern. Thus, Norfolk Southern never has to meet the requirement that Conrail must keep $500 million in its bank account. That covenant only applies when dividends are paid, and Norfolk Southern could acquire Conrail cash through the device of an intercorporate loan rather than a dividend.

Our proposal would also give ESOP beneficiaries the choice of selling their shares for $48 per share or of remaining owners of Conrail stock. (By contrast, Norfolk Southern, after many months, has not indicated how it will divide its $375 million offer to Conrail employees.) Conrail will buy shares from the ESPO beneficiaries who opt to sell, subject to the $500 million cash maintenance covenant. In the event that additional shares are tendered, Morgan Stanley has taken the further step of committing to arrange private financing so that all ESOP beneficiaries who wish to sell their shares will be able to do so.

After each of these cash commitments is met, and after capital expenditures, dividends, and return of "excess cash" to the government, Conrail's balance sheet would still show a 1985 ending cash balance of $620 million—well above the $500 million required to be on hand. (See "Summary Projections—Conrail's Forecasted Performance".) This analysis also shows that for the period 1986–1989, Conrail's cash balance at year end will never be less than $573 million. As a point of interest, Conrail management has indicated in public testimony that Conrail requires only $300 million in cash effectively to operate the company.

Question. What source of funds will be used to pay the federal government for its stock? Will Conrail cash also be used for this purpose? If the investors borrow the cash for their investment, will they not be able to use the attendant interest expense as a tax write-off?

Answer. We do not know the method by which any of the investors plans to finance the purchase of shares from the U.S. government, although none of the investors will use Conrail cash in making payment. Indeed, the covenants applicable to the Morgan Stanley proposal prohibit such use of Conrail cash.

Many of the investors manage pension funds or are investment managers involved principally in the domestic equity market. Thus, it is likely that all or a significant part of their investment in Conrail will represent new funds or funds from the sale of equities and will not be borrowed funds.

A number of investors are tax-exempt institutions, and, therefore, if they borrow funds to finance their purchases, they will not make use of interest expense to reduce taxes. For those investors who are taxpayers, there will be an opportunity to use interest expense to reduce taxes if they borrow the funds necessary for their investment.

It should be kept in mind that Norfolk Southern expects to borrow all of the funds necessary for its proposed purchase of Conrail shares, and it has received a letter from Morgan Guaranty Trust Company of New York indicating the latter's willingness to consider arranging such a credit facility.

Question. Do Morgan Stanley's financial projections assume any rate increase by Conrail? If so, what is the percentage rate increase assumed? Has there been any analysis of the effect of this rate increase on volume of traffic? How does this rate increase relate to projected cost increases? For each future year, what percent of

cost increases can be expected to be recovered through rate increases? Conrail's current five year forecast, on which our projections are based, assumes that railroad cost inflation will average 40 per annum in 1985–1989. Conrail's forecast assumes cost recovery of about 80% in freight rates. Its rates therefore decrease 1% in the 1985 recession and increase 3% per annum thereafter.

The projections of tonnage volume used by Conrail in making its financial projections are as follows:

[In million of tons]

1985	182
1986	186
1987	190
1988	190
1989	189

In our view, Conrail's management has made conservative and realistic assumptions in developing its most recent forecast. This is a practice, we believe, the company has followed in the past when providing projections.

The reasonableness of Conrail's projections has been confirmed by the July 29, 1985 staff report of the United States Railway Association.

QUESTION OF SENATOR RIEGLE AND THE ANSWER

Question. What is the status of your negotiations with rail labor? Have they agreed to the provisions in your proposals which affect labor contracts and conditions that currently exist in the Conrail system?

Answer. Conrail and Morgan Stanley recently initialled an agreement with members of the Conrail task force of the Railway Labor Executives' Association (RLEA) relating to the sale of Conrail. The agreement provides for the settlement of prior wage claims, retention of the Conrail ESOP, representation of labor on the Conrail Board of Directors and provision of labor protection benefits. By preserving Conrail employee interest in the ESOP and by providing representation on the Board, the agreement confirms a strong partnership between labor and management in guiding Conrail's future.

At a meeting on Thursday, July 25, 1985, the agreement received the endorsement of the full RLEA.

The CHAIRMAN. Next we have an investor panel: John C. Beck, managing partner, Beck, Mack, and Oliver, and chairman of the Investment Committee, Princeton University; John W. Snow, president, Chessie System Railroad; George Roche, vice president and director, T. Rowe Price; John Whitman, vice president, Citicorp Capital Investors.

Mr. Beck.

STATEMENTS OF JOHN C. BECK, CHAIRMAN OF THE INVESTMENT COMMITTEE, PRINCETON UNIVERSITY; JOHN W. SNOW, PRESIDENT, CHESSIE SYSTEM RAILROAD; GEORGE ROCHE, VICE PRESIDENT AND DIRECTOR, T. ROWE PRICE; AND JOHN WHITMAN, VICE PRESIDENT, CITICORP CAPITAL INVESTORS

Mr. BECK. Good afternoon, Mr. Chairman and members of the committee. I am John Beck, senior partner of Beck, Mack, and Oliver, investment counselors located in New York City.

I appear before this committee today as a charter trustee of Princeton University and chairman of the investment subcommittee of the board of trustees of that university, as well as a member of the Morgan Stanley investor group.

The Princeton Investment Subcommittee is composed of five Princeton graduates with over 100 years of collective hands-on investment management experience, with responsibilities for over $7 billion of managed investment assets.

Currently, Princeton's funds under management exceed $1½ billion. Princeton University, located in Princeton, NJ, was founded in 1746. It is among the Nation's premier undergraduate universities with an enrollment of approximately 4,800 students.

Morgan Stanley first approached Princeton as a potential Conrail investor in April 1985. It was at this time, Mr. Chairman, that as chairman of Princeton's Investment Subcommittee, that I became involved with the Morgan Stanley offer to purchase Conrail.

The management of an endowment as sizable as Princeton's requires a prudent investment philosophy with a perspective to achieve a steady premium long-term return on investment. I strongly believe that an investment in Conrail will offer Princeton this very favorable return.

Our investment subcommittee, drawing on the professional resources of the firms of three of the subcommitee members, conducted a thorough review of the Morgan Stanley proposal using our own economic and financial figures as well as those offered to us by Morgan Stanley. Our analysis indicates that an investment in Conrail would achieve a premium rate of return over that which we would expect to earn from our more typical readily marketable investments.

Conrail's recent performance is indicative of a well-managed efficient railroad. Our analysis and others like it clearly show that Conrail's future as a viable public railroad is best assured through independent public ownership.

I believe that Conrail's future as a railroad and as good investment is staked to its becoming a stand-alone railroad.

As one of the Nation's great universities, Princeton plays an important academic, cultural and economic role in the State of New Jersey. Conrail has likewise, with its hundreds of miles of rail within the State of New Jersey, played a similarly vital part in New Jersey's economy.

Princeton's investment in Conrail represents an investment in the future economic health of the State of New Jersey. Princeton is convinced that Conrail is a sound investment opportunity. Our $20 million investment represents a significant commitment of Princeton endowment money to Conrail. Our investment is based on our conviction with regard to the long-term viability and success of the railroad.

I thank the committee for this opportunity to provide it with information regarding Princeton's investment in Conrail, and I would be glad to try to answer any questions that any of the committee might have.

The CHAIRMAN. Thank you, sir.

Mr. Snow.

Mr. SNOW. Mr. Chairman, I am John Snow, president of the Chessie System Railroads, and I am appearing today on behalf of CSX Corp.

I would like to address the question of why CSX is an investor in the Morgan Stanley proposal, how we came to be an investor, and what our role is.

As you know, we have grave reservations about the public policy implications of a Norfolk Southern acquisition of Conrail. We feel

it would be thoroughgoingly anticompetitive; that it would result in a major restructuring of the railroad industry with enormous adverse effects upon the shipping public, the railroad industry, our employees, and our company. And therefore, we are pleased to be part of any reasonable alternative to the Norfolk Southern proposal.

We feel that Morgan Stanley has offered a good, sound and reasonable alternative. Our role in that is one of a passive investor. We did not seek Morgan Stanley; Morgan Stanley sought us out. Picking up the challenge which you apparently offered to Mr. Saunders and Morgan Stanley when they testified before this committee some time back. Our role is as a passive investor. We will not be a member of the finance committee of the shareholder group. We will not be a member of the executive committee of the group. We will not be a member of the board of directors of Conrail. We will not be a member of the executive committee of the board of directors of Conrail. We will have no say in the day-in and day-out management of Conrail.

We are thoroughly insulated from any relationship to Conrail itself. Our stock will be placed in a voting trust and if this committee or Secretary Dole or the Chairman of the ICC or the Speaker of the House of Representatives wishes to designate the trustee for us, we are perfectly prepared to allow them to do so.

Our goal is not to be a spoiler. Our goal is really a twofold one. It is, first, to make a good investment. And second, to provide a competitively structured alternative to the highly anticompetitive Norfolk Southern proposal. If Norfolk Southern proposal were allowed to go into effect, it would mean almost inevitably the end of the Staggers Act.

You, Mr. Chairman, would face irresistable pressures to amend the Staggers Act, and that would be disastrous for the railroad industry. You will undoubtedly raise with me, or have in your mind the question how can CSX view Conrail as a good investment today when June, a year ago, we wrote Secretary Dole and indicated that we had reservations about the long-term viability of Conrail.

I can answer you frankly and candidly by saying that our analysis then was far wide of the mark. We have learned by experience, no one more than me as I chaired the task force at CSX that did the analysis. We missed our guess on earnings by a wide mark. Whereas Conrail came in with results of about $500 million in earnings for 1984, we had them come in about $300 million. Whereas we had them coming in at about $450 million on cash, they actually came in at $800 million.

We have learned a lot since June 1984. And now, as the president of the Chessie System Railroads and competing day in and day out against Conrail, I can tell you they are a darn tough competitor. They have got a good route system; they have got low costs; they beat us in lots and lots of markets.

So, anticipating your question, I wanted to try and deal with it straight up.

The CHAIRMAN. Furthermore, consistency is the hobgoblin of little minds.

Mr. SNOW. Well, I was not going to say that, Senator. Senator, it is better to be inconsistent than to be consistently wrong.

On the question of an up or down vote, let me say we would be anxious to see this issue move, but I must say I have two reservations. One is we have not yet seen the Department of Justice analysis; we have not yet seen the computer printouts; we do not really know how they arrived at their conclusions in a thorough going way.

And second, and to me even more important, Mr. Chairman, is the fact that this divestiture scheme, which is really the lynch pin of the whole exercise, has not yet been reviewed by the Department of Justice. I would ask you in the name of fairness and to make sure that the Morgan Stanley proposal does get a fair review, that Justice present their results on the divestiture scheme and tell us whether or not they think the divestitures to P&LE and Guilford will in fact produce the anticompetitive antidote which they say is required.

I thank you for the opportunity to be here.

The CHAIRMAN. Thank you, sir.

Mr. Roche.

Mr. ROCHE. Good afternoon, Mr. Chairman. I am a vice president and director of T. Rowe Price Associates of Baltimore, MD. I am also president of the New Era Fund, a $500 million fund which has emphasized investments in the natural resource and related industries, including railroads since 1969.

My associate, James Kennedy, is also here today. He is vice president of our firm and senior analyst for transportation industries.

T. Rowe Price is an independent investment research and counsel firm which provides counsel to a family of 14 mutual funds and profit clients, including pension funds, profit sharing trusts, endowments, foundations, corporations and individuals. Our firm currently manages assets of approximately $18 billion.

I am here today on behalf of our firm as a member of the investor group organized by Morgan Stanley to purchase the Government's 85 percent interest in Conrail. We made a careful assessment of the investment opportunity of the Morgan Stanley proposal and recommended to our client, the Delaware State Pension Fund, that they commit $25 million on behalf of the Delaware Board of Pension Trustees toward the $1.2 billion cash offered by the investor group.

We were also retained by the State of Delaware to manage this commitment after it was made. Mr. Ernst Dannemann, chairman of the board, of the State Board of Pension Trustees of the State of Delaware, and Theordore Ashford, a consultant to the board, are also here today.

Our investment advice was based upon a very careful analysis of a team of investment specialists in our firm. We are familiar with and have been long-term investors in the railroad industry. We examined a number of operational, financial and other variables related to Conrail.

Our senior analyst has met the management of the company on several occasions and we have reviewed their corporate strategy. We concluded that Conrail can remain a sound, strong and viable and independent corporation. We also concluded that the stock of

Conrail would be an attractive investment, based upon its merits, despite some limitations including stock liquidity.

We recommended to the Delaware State Board Pension Trustees that they make their investment and commitment.

I thank you for the opportunity of testifying today and would be happy to answer any questions you might have.

The CHAIRMAN. Thank you, sir.

Mr. Whitman.

Mr. WHITMAN. Mr. Chairman, members of the committee, my name is John Whitman. I am vice president of Citicorp Venture Capital and Citicorp Capital Investors, Ltd., the two capital investment subsidiaries of Citicorp, NA.

These companies make equity investments for Citicorp for its own account and currently have over 110 investments with a market value in excess of $600 million. These two companies were established in 1968 pursuant to the Bank Holding Company Act of 1968.

We are here as a participant in the Morgan Stanley public offering proposal to which we have committed $50 million. Citicorp has been involved in the evaluation of Conrail as a stand-alone public offering possibility since December of 1983. We were in fact the author of the other public offering proposal referred to in previous testimony earlier today and were one of the original 16 bidders for Conrail in June of 1984.

The key question that everyone asks about our willingness or desire to invest in Conrail is why are we willing to do it and what is the viability of Conrail. Our view in December of 1983 was reinforced in June of 1984, was further reinforced by the performance of Conrail through the end of 1984, and finally through the first quarter performance of 1985.

And our view is still that Conrail is a sound and attractive investment as a viable stand-alone operating entity; and that, as such, will help put a great deal of power and economic aid into the area which it serves as a stand-alone entity in which we have invested many billions of dollars.

The major reasons behind these views are that management has been able to effect a turnaround of major proportions from a loss of $400 million in 1978 to a profit of more than $500 million in 1984, and has been able to show constant improvement in spite of major obstacles such as the heavy recession of the 1982–83 period.

The second reason is that the right-of-way and equipment of Conrail is in first class condition. After the Morgan Stanley transaction is put into effect, Conrail will be the only Class I railroad in the United States without any mortgage indebtedness on its right-of-way or any other indebtedness other than some normal equipment financing.

A third major view underlining our support of the proposal comes from the fact that the projections made by the USRA, Conrail and Morgan Stanley, with which we concur, indicate that Conrail will be able to continue profitable operations over the foreseeable future, even when substantial recessions are taken into account.

Finally, because of the above reasons, the Conrail investment proposed by Morgan Stanley offers a reasonable and acceptable rate of return to the long-term investors.

I appreciate the opportunity of addressing the committee and will be glad to answer any questions that you may have.

The CHAIRMAN. Gentlemen, thank you very much. I particularly appreciate your enthusiastic commercial for Princeton University, Mr. Beck. Truer words have never been said in this committee room.

We even have cards of committee members printed in orange and black up here.

Mr. Snow, it is my understanding from the proposal of Morgan Stanley that there are limitations as to how much stock could be owned by any one investor for a 5-year period of time.

What would there be to prevent CSX from trying to acquire the whole thing at the end of 5 years?

Mr. SNOW. Senator, the only thing that would prevent us at the end of 5 years would be that we would have to go through an Interstate Commerce Commission proceeding, as any other railroad would who would seek to acquire it. I can say that we don't at the present time have any intention to do that but what would stand in the way would be the necessity to go through the 31-month ICC proceeding.

The CHAIRMAN. But an administration which is not troubled by Norfolk Southern acquiring Conrail would presumably not be, for competitive reasons, troubled by CSX acquiring Conrail?

Mr. SNOW. Well, I think I would make a distinction between the Department of Transportation on the one hand and the administration on the other, and secondly between the Interstate Commerce Commission which would have the responsibility to make that determination 5 years hence.

It would make a real difference between the Interstate Commerce Commission and their procedures and the standards they apply and the standards that have been applied to the Norfolk Southern/Conrail acquisition so far.

As a lawyer who has practiced for years before the Interstate Commerce Commission, I don't have any reservations in saying that CSX and Norfolk Southern would face an almost impossible burden of proof in trying to take this acquisition through the Interstate Commerce Commission.

To my knowledge, the ICC has never approved a merger as anticompetitive as this one.

The CHAIRMAN. Let me tell you the basis of my concern about this panel's testimony. On the one hand, we have a statement from Mr. Beck, who was quoted in the Wall Street Journal speaking about the Princeton endowment, "The only way we are going to continue to get a premium return is to try with a limited part of the endowment to draw on unique opportunities. The Conrail venture looked as if it offers a prospective return of about 50-percent better than we could reasonably expect from our portfolios as a whole."

In other words, he is looking on this as a premium investment. This is going to hopefully return 50 percent more than the average run-of-the-mill investment would.

On the other hand, we have previous statements by CSX that Conrail could not stand alone.

Now, Mr. Snow says, well, he has changed his mind about that, but apparently Mr. Watkins has not.

Mr. SNOW. That is not true, Senator. I am reflecting his views.

The CHAIRMAN. OK. Then this is a misprint in the Wall Street transcript of June 10, 1985. In an interview printed in that paper Mr. Watkins was asked:

> Originally your company felt that it had some grave doubts about the sustainability of Conrail. I take it that since that time you have had a change of heart. The first part of the question is what caused the change of heart. And what is your current position on the long term viability of Conrail?
>
> Mr. WATKINS. Let me start with the first part . . . and that is the future of Conrail.
>
> First of all, no, we have not changed our outlook and attitude on Conrail. We have said that what our analysis and the analysis of other companies and other groups indicated was over the long term—the long term we can describe rather loosely, but let us say beyond ten years—the northeast would be best served by two competitively balanced rail systems. I said that last year, and continue to say it.

And so on.

> Recognizing political reality, we took a look at what is politically possible. Two things have happened and I think have modified our views somewhat, not changed them but modified them. Number one, Stan Crane and his people have done better in 1984, and from what we can tell are doing bettern in 1985 than we anticipated.
>
> Therefore, although we said initially that by 1989 or 1990 Conrail would have some problems, we perhaps could now put that out a few years beyond until the early to mid 1990s, let's say. But again, our assessment of the long term future of Conrail, long term viability of eastern railroads still stands.

That seems to me to be not exactly a flipflop on the original view but a statement that while it might limp along for a few more years than originally anticipated, it is Mr. Watkins' view that as a stand alone railroad, Conrail has a very limited future.

Mr. SNOW. Senator, I think that would overstate his view. I think his view is, as he has suggested in the article or in the Wall Street transcript, which I had not seen, his view is that the best solution long term would have been a division of Conrail between Norfolk Southern and CSX. Then we would have had a competitively structured railroad system over the whole reach of the region. Then we would have avoided the serious implications for revising the Staggers act and all the harm that would visit on the railroad industry with the prospect of returning to the conditions of the 1970's when under regulation one quarter of the rail plant was in reorganization or bankruptcy.

I think Mr. Watkins is frank to say that the traffic levels in the Northeast will either decline or stabilize but will not grow.

The CHAIRMAN. Well, how could Princeton University expect a 50-percent premium on its investment if you have traffic patterns that at the best will not grow?

Mr. SNOW. Let me suggest the answer is twofold. One is that Conrail has a good management team that has a proven record of managing in stable and declining markets. They have yoked profits out of decline. And second, it is the $1.2 billion price. We think the company is worth considerably more in the open market than $1.2 billion, and that is the way you arrive at that conclusion.

The CHAIRMAN. But that is the Boone Pickens line of reasoning.

Mr. SNOW. No, it is not, Senator. The price that has been pegged at $1.2 billion is less than a public offering would yield. Nobody in our group is proposing to go in, raid the company and sell it piecemeal. What we are proposing to do through Morgan Stanley is simply have a subsequent public offering.

The CHAIRMAN. Profit of the stock.

Mr. SNOW. Sure, have a subsequent public offering that would yield more than $1.2 billion.

Mr. BECK. Senator, if I might add, as part of our due diligence, we did turn, as we often do, to our alumni body for counseling, and one of our alumnis, president of one of the Nation's largest and certainly best managed railroads, had looked at the property very carefully with the thought possibly of entering the fray and had decided not to. When I asked whether he would recommend that we go forward with our investment, he encouraged us very strongly to do so.

The CHAIRMAN. Senator Rockefeller?

Senator ROCKEFELLER. I have no questions, Mr. Chairman.

The CHAIRMAN. Gentlemen, thank you very much for your testimony.

Finally, we have a panel of investment bankers, Vincent Mai of Shearson Lehman Bros., James Voytko of Paine Webber, and Kenneth Brody again.

Mr. Mai?

STATEMENTS OF VINCENT MAI, MANAGING DIRECTOR, SHEARSON LEHMAN BROS.; JAMES VOYTKO, FIRST VICE PRESIDENT, PAINE WEBBER, INC.; AND KENNETH D. BRODY, PARTNER, GOLDMAN SACHS & CO.

Mr. MAI. Mr. Chairman, gentlemen, I am a managing director of Shearson Lehman Bros., and our firm has been retained by Norfolk Southern to work with them on the whole Conrail acquisition. We have had a full team working on this endeavor for a period of approximately 15 months. So we are talking here about a process which for us has been a very long, intensive and an ongoing one.

You have heard a lot of testimony this afternoon, and I am really going to try to keep my points very brief, and basically address what I think are the three essential points which have come out of the testimony you have heard this afternoon. Those points are, No. 1, the perspective of the investors, the Morgan Stanley group versus Norfolk Southern; second, the ability of Norfolk Southern or at least the ability of the Government to police the covenants that are imposed on Norfolk Southern; and third, just to touch once again on the tax aspects which I think are important.

Now, so far as the perspective of the investors are concerned, Mr. Saunders testified this afternoon that the best testimony available regarding the long term viability of Conrail on a stand alone basis was the fact that this very fine group of institutional investors had been put together, and you could not have anything speak better of the long term viability of Conrail than that.

And I think he also goes on to say that the intention of Morgan Stanley in this group is to file a registration statement and to basically sell the stock as quick as possible. And there is nothing wrong

with that. That is what those investors are there for, to increase their return.

But I think to suggest that those investors are in a tender transaction because of a long term commitment to the railroad industry I think certainly does not square with the facts. It is wrong. They are in this deal because they see an opportunity to make a quick profit, and that is what they are there for, and I think the best test of that is if you had to take away the registration rights, if you had to put some cap on the amount of dividend that could be paid out, which would be less than $120 million, I think you would very quickly find that that investment group would evaporate.

Contrast that with Norfolk Southern. It is a company which has been in the railroad business for a long time. They want to acquire Conrail because they see tremendous commercial benefits through the association. They are not in this for any short term gain. They are not going to have their judgment influenced by any short term move in the stock market. They are in this because they are committed to the railroad business and they want to integrate Conrail with their operations on a long-term basis.

I think it is a central point. We are dealing with one group, we are looking at this long term, and you are dealing with another group that is looking at it short term. The people who will bear the risk of the investment in Conrail are the public shareholders to whom the stock will be sold in the event that there were problems with Conrail down the road. It is not the Morgan Stanley group.

I might just add, Mr. Chairman, just very quickly, that as it relates to the viability of Conrail on a stand-alone basis, to my mind it is absolutely clear that the Morgan Stanley proposal in effect genuinely weakens Conrail. I think there are several reasons for that.

No. 1, they take cash out of the closing to settle the wage claims for the ESOP. No. 2, in order to stimulate the interest of this investment group, they have to pay a very high dividend rate. Number three, their estimate of capital expenses, Conrail going forward, consistently are well below the estimates of both the management of Conrail and of Norfolk Southern. And finally, there is a covenant in the Norfolk Southern proposal which says that in the event Norfolk Southern does not meet its capital expenses, it will refund previously paid dividend in order that it can get up to the level of the plant capital expenditures. The Morgan Stanley group does not make such a covenant.

The second point I would like to address is something which Mr. Saunders and the Morgan Stanley group said both at this morning's hearings at the House subcommittee and again this afternoon that relates to the impossibility of policing the covenants that are imposed on Norfolk Southern with respect to Conrail with respect to capital expenditures, cash, and so forth.

I think that this is an irresponsible allegation. I think that one of the reasons that Norfolk Southern was chosen by the Department of Transportation was the fact that this company has a tremendous reputation of quality service, of integrity, and I think to claim that this company, having testified both before the Senate and the House that they were going to stick to certain covenants, I think to allege that somehow after they have closed this transaction they

are not going to do so simply is a tremendous disservice to one of the great companies in the United States.

The other point is that Norfolk Southern is a holding company. Today the only assets of Norfolk Southern are two wholly owned subsidiaries, one of the Norfolk & Western Co., and the other one is the Southern Railroad. They are going to add, in the event that they acquire Conrail, a third wholly owned subsidiary which will be Conrail.

They have testified repeatedly and they have made commitments repeatedly to the effect that Conrail, No. 1, will have separate financials; they will do separate borrowings; they will have separate ratings; they will do separate filings with the ICC. So therefore, it is going to be very straightforward and simple to track all the time what is happening with Conrail with respect to the various covenants that they have committed to.

The final point I would like just to address is the question of the taxes, and it has been addressed by Mr. Brody and others early on, but I would just like to repeat and to emphasize that the numbers that the Morgan Stanley group are using, claiming that the Morgan Stanley proposal gives an advantage of $600 million from a tax perspective versus Norfolk Southern simply does not bear the test of scrutiny. I think anybody who has looked at these numbers will confirm that at best from the standpoint of the Government we are talking about a difference which is substantially less than $100 million.

We have had Coopers & Lybrand who have looked at this from the standpoint of DOT. We have had Peat, Marwick who have looked at it from the standpoint of Norfolk Southern. We have had a battery of accounting firms, legal experts look at it. The number is less than $100 million, and I cannot for the life of me see the validity of continuing with the $600 million number which has been used in the Morgan Stanley proposal now for several weeks. It simply does not stand the test of scrutiny.

Thank you, Mr. Chairman.

[The statement follows:]

STATEMENT OF VINCENT A. MAI, MANAGING DIRECTOR, SHEARSON LEHMAN BROTHERS, INC.

INTRODUCTION

Overview

I am Vincent A. Mai, a Managing Director of Shearson Lehman Brothers Inc. My career in the investment banking field spans 15 years, and I have been a Managing Director of Shearson Lehman Brothers Inc. for nine years. Our Firm has considerable expertise in the railroad industry. We have served as an advisor to Southern Railway Company (a predecessor of Norfolk Southern Corporation ("NS" or the "Company")), the Trustees of Penn Central Transportation Co. and Erie-Lackawanna Railway Company and continue to be an advisor to the Trustee of Milwaukee Railroad Estate. We have also provided financial advice from time to time to The Pittsburgh and Lake Erie Railroad Co., Grand Trunk Corporation, Guilford Transportation Co., the Missouri-Kansas-Texas Railroad Company, Texas Mexican Railway and Fruit Growers Express Company.

Shearson Lehman Brothers Inc. has been directly involved in the process of the Conrail sale as financial advisors to NS, prior to and since May 10, 1984 when the United States of America published notice in the Federal Register soliciting offers from any and all parties interested in purchasing the United States' interest in the Common Stock of Conrail.

Shearson Lehman Brothers Inc., one of the nation's leading investment banking firms, is well qualified in the fields of general corporate finance, valuation analysis and the securities markets. As it relates to this transaction, we have particular strengths in both the equity markets and in the area of mergers and acquisitions. During 1983 and 1984, we lead managed (i.e. had primary responsibility for) 48 initial public offerings totalling more than $1 billion and 71 common stock offerings totalling more than $2 billion. From 1980-1984, we have acted as financial advisors on more than 250 completed merger and acquisition transactions which places my firm as one of the leading participants in this field in the U.S.

In our capacity as financial advisors to NS, we have undertaken a comprehensive review of Conrail, together with the sale process itself in order to enable us to express our views on a variety of issues surrounding the proposed sale of Conrail. Today, I am here to comment on the Morgan Stanley proposal to acquire Conrail.

Conclusions

The following conclusions represent the views of Shearson Lehman Brothers Inc., as investment bankers:

1. The Morgan Stanley proposal does not offer additional cash proceeds to the U.S. Government above those in the NS Offer. There is limited value attributable to the warrants to be given to the Government, and Morgan Stanley's estimate of the tax cost of the NS Offer is inaccurate and not substantiated.

2. NS guarantees the employees $375 million in cash (or NS common stock) and provides generous labor protection particularly when compared to the Morgan Stanley proposal.

3. Careful scrutiny is required to assess the commitments of Morgan Stanley's investor group to:

   a. Proceed with the offer in a weak stock market environment or if the economic outlook, and therefore Conrail's potential earnings power, deteriorates over the next few months.

   b. Maintain Conrail's viability and level of service in the Northeast.

   Since the Morgan Stanley group intends to resell its stock quickly in a public offering (which explains the requirement that a registration statement be effective on the date of Closing), no assessment of the long-term commitment to the railroad industry of those potential future Conrail owners can be made.

4. Combining Conrail with NS creates a strong railroad company with significant financial resources, the ability to weather any severe recessions which may occur, and the capacity to satisfy the U.S. Government's public interest covenants under the direction of a proven management team which preserves the interests of shippers, labor and the areas served by Conrail. Conrail under the Morgan Stanley proposal, quite simply stated, does not provide for these results, particularly in light of Morgan Stanley's intention to use Conrail's cash to finance a portion of the purchase price.

5. Norfolk Southern's covenants are far stronger than Morgan Stanley's and will be in effect for five years. Morgan Stanley's proposal, on the other hand, contemplates the termination of any obligation to abide by these covenants as soon as the investors have sold their stock - which could occur in much less than five years.

While we clearly need more information from the Morgan Stanley group before we can compare with complete accuracy the respective merits of the NS Offer and Morgan Stanley proposal from a strictly financial standpoint, we are confident about the conclusions stated above. In terms of sale proceeds to the Government (and the taxpayer) the differences between the two offers are insignificant, even allowing the most favorable interpretation of the various open issues in the Morgan Stanley proposal.

To the extent there is a major increase in the ultimate amount raised for Conrail through a public offering, the beneficiaries will be the Morgan Stanley group and not the Government or the taxpayer. It is, of course, impossible to predict whether this investment group will realize such a gain since this will depend on stock market conditions prevailing in the future. Nobody can make predictions with confidence in this connection. On the other hand, if stock market conditions were adverse we, as an investment banking firm, would have serious questions to raise about Morgan Stanley's ability to retain indefinitely the commitment from its entire group of investors when they clearly would not stand to make a quick profit from a public sale. As a single prospective investor in Conrail, committed to the railroad industry on a long-term basis, NS clearly does not have the "fair weather" perspective that the financially-oriented Morgan Stanley group has - particularly in a tough stock market environment.

If we are correct in our judgment that the differences between the two proposals, as they relate to the proceeds received by the Government, are insignificant, then the final judgment on the respective merits of the two offers must depend on which prospective offer is likely to ensure the long-term viability of Conrail as an efficient, profitable railroad company providing quality service. From this perspective, it is obvious that the NS Offer is overwhelmingly superior to the Morgan Stanley proposal. The main elements in comparing the Morgan Stanley and NS offers are reviewed below.

CASH PROCEEDS TO GOVERNMENT

The Morgan Stanley proposal does not offer additional cash proceeds to the U.S. Government above those in the NS Offer. In fact, Morgan Stanley's projections indicate that Conrail will not pay any Federal income taxes for the foreseeable future.

Limited Value Attributable to Warrants

While Morgan Stanley and NS both offer $1.2 billion in cash ($48/share), Morgan Stanley also proposes to give the Government 1 million warrants exercisable at $48/share. These warrants will have limited value to the Government, however, unless the Conrail stock price appreciates significantly. If Conrail's stock trades up a generaous 20%, the inherent value of the warrants will be only $9.6 million. Adding an optimistic $14.4 million premium for the remaining warrant life, the total valuation of the warrants would only be approximately $24 million. The Morgan Stanley investors, however, would simultaneously gain $240 million if the Conrail stock price were to appreciate 20%. The Government warrants thus have little incremental value when compared with the $1.2 billion purchase price or the upside potential the investors are proposing for themselves.

Tax Cost Estimated At Less Than $100 Million

The Morgan Stanley proposal does not fairly estimate the tax cost to the Government of the NS Offer. Under the NS Offer the present value of the tax cost, if any, is substantially less than $100 million. It is not the $600 million which Morgan Stanley claims and, in its May 31, 1985 response to our critique of its proposal, neither substantiates its earlier estimate nor disagrees with the NS estimate. It is perhaps worth noting that the opponents of the NS Offer have produced estimates of the present value of the tax cost which are so divergent as to question their credibility. In addition, over the past few months these estimates have been reduced substantially from nearly $1 billion to the levels claimed as valid today. The continual decline in these estimates further raises doubts as to their accuracy.

The Morgan Stanley proposal claims to eliminate alleged tax losses to the Government which Morgan Stanley estimates at $600 million: $366 million in present value of NS' upstreaming of Conrail tax losses and $245 million in lost Federal railroad retirement and unemployment receipts. Morgan Stanley has provided no details or justification of these numbers and we are unable to determine their source.

It must be pointed out that NS is now and will continue to be a substantial tax payer. Conrail has never paid Federal income tax, and Morgan Stanley's projections indicate that this trend will continue for the foreseeable future. While the analysis of any tax cost to the Government is complex, the net result of the combination of NS and Conrail is that, at most, the present value of any net reduction in NS taxes attributable to Conrail depreciation will be substantially less than $100 million. Additional information about the assumptions behind the Morgan Stanley proposal is clearly required.

PROCEEDS TO EMPLOYEES

By not guaranteeing 100% cash proceeds to the employees for their Conrail stock, and in making no commitment on labor protection, the Morgan Stanley proposal is weaker than the NS Offer.

The Morgan Stanley proposal to employees differs from the NS Offer in several ways. First, the employees will receive cash proceeds of $230 million under the Morgan Stanley proposal, whereas they will receive $375 million under the NS Offer. Under the Morgan Stanley proposal, employees will retain their 15% ownership interest. There is no guarantee in Morgan Stanley's proposal that Conrail employees will be able to receive cash for their entire 15% interest in Conrail. Under the NS Offer, employees are offered all cash or can take an equivalent amount of NS common stock.

Labor protection under the NS Offer is substantially stronger than under the Morgan Stanley proposal. NS offers New York Dock Protection to employees adversely affected by the merger and a full one-year protection for employees whose positions are affected due to other efficiencies. Morgan Stanley refers to the collective bargaining process as a means of creating job protection. Under adverse economic conditions, labor could lose substantially in such a process.

Further, Morgan Stanley was unfair in publicly evaluating the NS Offer to employees. They refer to "forcing out" the existing ESOP for $75 million. NS, however, intends to pay full value to the ESOP and settle any prior claims as part of its cash payment of $375 million. Morgan Stanley also asserts that NS gives Conrail employees no opportunity to share in the ownership of Conrail; yet the employees may, at their option, elect to take all their $375 million in NS common stock rather than in cash. Finally, Morgan Stanley asserts that up to 10,000 jobs will be lost if NS acquires Conrail. They cite certain elements of organized labor as a source for this figure and ignore NS' own published estimates which show a net loss of approximately 1,200 jobs.

COMMITMENT OF THE INVESTORS

Commitment to Proceed with Offer

Considering the substantial market risk assumed by the investor group, the firmness of their commitments must at least be confirmed. The credibility and commitment of NS as a single buyer, with a long lasting commitment to the railroad industry and with in excess of $1 billion in cash currently on hand, is without question.

The Morgan Stanley investors are financially-oriented. They are interested in a possible investment in Conrail because they feel such an investment could offer them an above-average financial gain. If circumstances prohibit their ability to realize such a gain, their commitment to this financing and to Conrail on a long-term basis is surely suspect. Such circumstances could include a weak stock market environment at the time investors are asked to commit $1.2 billion, or a weak economy which causes Conrail's existing and prospective earnings power to decline. We would, of course, be ready to revise our opinion in this regard if we had the opportunity to review Morgan Stanley's written agreements with its investor group and if these agreements represented unequivocably a commitment to invest rather than an expression of interest on the investors' part. In contrast, Norfolk Southern is committed to developing Conrail as a premier railroad company which complements its existing railroad operations and allows Norfolk Southern to compete more effectively with CSX. Norfolk Southern is thus interested in acquiring Conrail for long-term strategic reasons which have nothing to do with the short-term vagaries of the stock market or the economy.

Other issues emerge in the analysis of the multiple investor approach. Among them: What happens to the proposal if several investors do walk away? How much stock is each investor committed to purchase? What happens if the investors are unable to agree on this stock distribution? Whose stock will be sold in the first phase of the public offering and what happens if more investors want to sell their stock in the first phase than the market can absorb? These questions must be answered to remove doubt on the degree of the commitment made by the investors.

Long-Term Commitment to Conrail and the Railroad Industry

The Morgan Stanley proposal does not insure that a future Board of Directors will not break up Conrail in an attempt to realize greater value from the sale of its assets. Furthermore, the ownership restrictions on CSX or any other investor apply for a maximum of five years and in all likelihood, given the intentions of the investor group, will terminate before the five year period has expired.

Since the Morgan Stanley group intends to resell its stock quickly to the public, no assessment of the future Conrail owners can be made. The fact that the proposal requires an effective registration statement at the Closing confirms this. The Morgan Stanley proposal contains no restrictions on a future investor buying Conrail's stock and trying to realize a higher value by breaking Conrail apart. Such an action would clearly be detrimental to the railroad industry in the Northeast. NS however, has made a long-term commitment to the railroad industry and has agreed to operate Conrail as a going concern.

Furthermore, the restrictions on investor ownership expire at the earlier of five years or the sale or transfer of the investor's stock. CSX, for one, has already stated publicly that it believes the best way to deal with Conrail is to break it up, presumably taking the most profitable routes for themself. It would be possible for CSX to attempt to accomplish this goal with a five year period from the date of Closing.

LONG-TERM ECONOMIC VIABILITY OF CONRAIL

By depleting Conrail's cash in the acquisition, the Morgan Stanley proposal creates a financially less viable railroad than Conrail would be as part of a NS/Conrail combination. This fact is obscured in the M rgan Stanley proposal by very optimistic projections. Furthermore, the Morgan Stanley investors are not required to make additional investments should Conrail meet economic difficulties.

A NS/Conrail combined entity will clearly be strong and more economically viable than the Conrail created under the Morgan Stanley proposal. The additional cash of $300 million beyond the required $500 million minimum cash balance that NS has committed to leave in Conrail, combined with NS' cash reserves and substantial debt capacity, creates a financial powerhouse. On the other hand, Morgan Stanley proposes to use Conrail's cash to pay prior employees' claims and to purchase employee stock held by the ESOP. In fact, the covenants in the Morgan Stanley proposal permit Conrail's cash to fall below $500 million if such cash is used to purchase ESOP stock.

We should note that the financial projections contained in the Morgan Stanley proposal are optimistic. They show strong earnings and positive cash flows in every year except 1987, when an economic downturn occurs. In each year, capital expenditures are at least $500 million, the cash balance never falls below $500 million and dividends of $121 million are maintained.

However, the Morgan Stanley projections differ substantially from those of the USRA. Under the USRA projections, cash flow is significantly lower and the $121 million annual dividend to the Morgan Stanley investors could not be maintained without violating Conrail's cash balance covenants. In addition, USRA projections for capital expenditures exceed those in the Morgan Stanley proposal. For example, in 1988, the Morgan Stanley projections for capital expenditures fall $281 million short of the USRA projections. There is a real possibility that Conrail could run into cash flow problems under the Morgan Stanley proposal, resulting in insufficient capital expenditures, inadequate maintenance, reduced dividends and a less viable railroad.

It is misleading to assume that if Conrail can remain viable as a stand-alone entity for the next three years, it can do so indefinitely. While the timing of a recession may be subject to debate, previous experience suggests a strong likelihood that a recession will occur sometime between now and 1990. Relying on optimistic projections of the short-term future is a grave mistake, particularly when Conrail will be without excess cash to weather a recession and a parent company which is committed to the rail industry for the long-term and has available resources to survive economic downturns. One can not overlook the continuing echo, heard during recent Congressional testimony, of those knowledgeable about the railroad industry and its economics that over the longer-term (i.e. ten years) Conrail's ability to remain as a viable stand-alone entity is not assured.

PUBLIC INTEREST COVENANTS

The Morgan Stanley proposal does not meet all the required covenants mandated by the Department of Transportion. NS' Offer does. Furthermore, the Morgan Stanley proposal states it would be inadvisable to operate Conrail with the covenants and suggests Congress should eliminate them. Finally, NS has made a firm commitment that the covenants will remain in effect for five years, while Morgan Stanley's covenants will only remain in effect for as long as any of the investor group continues to hold Conrail stock. This matter of important public policy cannot be ignored.

While Morgan Stanley has attempted to comply with all of the Department of Transportation's covenants, NS' covenants are far stronger. As mentioned above, Morgan Stanley uses Conrail cash to meet some of the terms in the sale. Morgan Stanley has estimated that nearly $375 million of Conrail's own cash will be used to pay labor to settle prior claims and to purchase some shares held by the ESOP.

Secondly, the dividend restrictions under the Morgan Stanley proposal are not nearly as stringent as they are under the NS Offer. The Morgan Stanley proposal allows its investors to take dividends of 40% of the net income for the six month period prior to Closing. Using Morgan Stanley's estimate of $364 million of net income in 1985, this additional dividend represents approximately $72 million. There are no restrictions to prevent the Morgan Stanley group from taking this $72 million in cash on the date of Closing thereby leaving Conrail in a weaker financial position.

Furthermore, under the Morgan Stanley proposal, the suggested annual dividend payments of $121 million represent an initial yield of over 8.4%. This dividend yield exceeds that of all other major railroads, including NS by more than 3%. The Morgan Stanley group offers no reason or justification for this excessive dividend level, which will further deplete Conrail's available cash.

NS' capital expenditure requirements are stricter than those under the Morgan Stanley proposal. NS is required to refund any previously paid dividends if Conrail cannot meet the $350 million/year minimum capital expenditure requirement. Under the Morgan Stanley proposal, Conrail is prohibited only from making future dividends if the requirement is not met. More importantly, there are no requirements on any of the Morgan Stanley investors to make additional investments should Conrail meet economic difficulties, while NS clearly will contribute any needed incremental capital.

It is also important to note that Morgan Stanley states that while its investor group will agree to covenants, "it would not be advisable for a publicly held corporation to operate under such restraints." The Morgan Stanley proposal strongly urges Congress to "carefully consider whether such covenants are appropriate for an independent, publicly held Conrail, as they inhibit management prerogatives." It sounds as if Morgan Stanley may intend to fight the covenants at a later date.

TOTAL PROCEEDS ACTUALLY PAID BY THE MORGAN STANLEY GROUP

By using nearly $375 million of Conrail's cash and permitting themselves additional dividends of up to $72 million out of pre-acquisition earnings, the Morgan Stanley group actually pays significantly less money for Conrail than NS.

The Morgan Stanley proposal uses nearly $375 million of Conrail's cash to meet employees' prior claims and to buy back an unknown amount of ESOP stock holdings. Furthermore, the investor group will be allowed to pay itself dividends of 40% of the net income in the six month period prior to Closing; whereas under the NS Offer, Conrail can pay dividends of only 40% of post closing net income. This cash drain of investor dividends would weaken Conrail on an ongoing, long-term basis.

We have analyzed the actual consideration paid at Closing under the NS Offer, under the Morgan Stanley proposal assuming Conrail employees choose to retain their 15% ownership and under the Morgan Stanley proposal assuming 50% of the employees choose to cash out. (See Table A.) Clearly, the Morgan Stanley proposal is not as generous to the Government and to Conrail employees as it purports to be. In addition, to the extent that the Conrail employees are cashed out, the Morgan Stanley group is able to use Conrail's own cash without requiring further financial investments from the investors.

Moreover, the Morgan Stanley proposal contemplates that Conrail would buy back the warrants (or repurchase shares if the warrants are exercised) or repurchase Conrail shares from the ESOP and that such purchases of Conrail warrants or stock would not be limited by the $500 million cash maintenance test. Any benefit to the Government would thereby be funded out of Conrail's own resources at no cost to the Morgan Sanley group. Indeed, the Morgan Stanley group would be further advantaged by avoiding the dilution of their equity interest that would occur if new shares were issued upon exercise of the warrants.

In conclusion, it is our judgment that the difference in cash proceeds received by the U.S. Government from a sale of Conrail to either NS or the Morgan Stanley group is insignificant. Therefore, the merits of the two proposals need to be weighed using other criteria. When the commitments to Conrail and the rail industry of NS are contrasted with those of the Morgan Stanley group and when the long-term viability of Conrail as a stand-alone entity is assessed, the benefits to the Government from the NS Offer become readily apparent. The NS offer, too, provides the Government with the opportunity to return Conrail to the private sector with assurances that the public interest covenants will be met; the Morgan Stanley group gives no such assurances. A Conrail, whose long-term viability is enhanced, providing quality service on a profitable basis presents a strong and convincing argument for the NS Offer.

TABLE A

	NS Offer	MS Proposal Assuming Employees Retain 15% Ownership	MS Proposal Assuming 50% of Employees Cash Out
Cash to Government	$1.2 Billion	$1.2 Billion	$1.2 Billion
Cash to Employees for Conrail Stock and Prior Claims	375 Million	$230 Million	335 Million
Conrail Cash Used to Settle Prior Claims	-	(230 Million)	(230 Million)
Conrail Cash to Buy Employees Stock	-	-	(105 Million)
Total Cash Paid by Purchasers at Closing	$1.575 Billion	$1.200 Billion	$1.200 Billion
Additional Dividends Available to Investors from Pre-Acquisition Earnings	-	(72 Million)(a)	(72 Million)(a)
Actual Cost to Investors	$1.575 Billion	$1.128 Billion	$1.128 Billion

(a) 40% of 6 months income for 1985.

The CHAIRMAN. Thank you, sir.

Mr. Voytko.

Mr. VOYTKO. Thank you, Mr. Chairman, and members of the committee. I am glad to be here once again on Conrail. I might note at this time that I have no financial interest, either direct or indirect, in the outcome of this debate, although being in the financial business, I am always looking for one.

Is an independent Conrail a viable concern as it would be configured under the Morgan Stanley proposal?

If by viable you mean staying out of bankruptcy and avoiding a total collapse of rail service, I believe the answer is yes for a while, and with a benign economic climate, perhaps for a while longer. However, is by viable you mean with earnings, cash flow and dividends that will assure shippers of continued service and adequate reinvestment in Conrail's plant, assure rail labor of stable employment, assure stockholders of secure dividends and appreciation potential, then I have grave doubts.

My doubts spring from the fact that even taking Morgan Stanley's earnings and cash flow projections at face value, though I feel some key assumptions may prove far too optimistic, Conrail's free cash flow turns negative even during a mild, 1-year recession. If you play "what if" with the Morgan Stanley projections and, for example, look at what would happen with a modestly more troublesome but equally brief recession with everything else remaining constant, the cash flow deficit triples.

If you go further and you assume a relatively mild 2-year recession and the elimination of investment tax credits as is currently proposed by the administration, the cash flow deficit widens even further and in fact stays strongly negative even after the significant rise in cash-flow from sources other than net income that is projected in the Morgan Stanley forecast.

Now, negative cash-flow for a while does not automatically mean bankruptcy, but it does mean some combination of the following: More cuts in the labor force, service reductions and asset abandonment, additional borrowings and thus more leverage, deferred maintenance, reduction in working capital and/or dividends, cash infusions from outside parties.

The point of this is that not all of these disturbing events are sure to happen, but rather, the point is that Morgan Stanley's projections for Conrail's cash-flow are critically dependent on both favorable economic trends and favorable pricing trends within the rail industry through the future.

But even accepting Morgan Stanley's basic assumptions, the margin for error is not especially big, and the cost of erring is to face some combination of the unpleasant events noted above, events I assume you wish to avoid.

The best way to pin down an investment analyst like myself is to ask whether I would invest my own money or recommend that Paine Webber invest its capital in an independent Conrail at $48 a share with the covenants prescribed. My answer is no; I think there are far better investment opportunities available. And, of course, by definition—all else being equal at the time—it seems unlikely that I could recommend Conrail's stock to my clients when Morgan Stanley resells it into the market which presumably would occur as soon as possible after gaining control of Conrail and at a price as much above $48 as they believe the market will bear.

How do you compare Norfolk Southern's bid with Morgan Stanley's? Let us look at a couple of factors. Avoiding stock market risk: My friends from Morgan Stanley indicate that they are stepping into the Government's shoes. That is true. The Morgan Stanley approach accomplishes that. Unfortunately, so does the Norfolk Southern approach. There is really no difference there.

Avoiding long-term financial risk, that is, ensuring that if adverse events do happen and cash is needed, the taxpayer is not called upon in some way to assist Conrail again. Here it would seem that the Morgan Stanley proposal which could leave Conrail short of cash under plausible scenarios falls short of the protection offered by merging Conrail into the Norfolk Southern system.

How about avoiding service risk, that is ensuring that if Conrail's future is less rosy than we might hope, service to shippers and the maintenance of Conrail's assets do not suffer. Here again, this Morgan Stanley proposal falls short of the protection issued by folding Conrail into the Norfolk Southern system.

This point as it relates to the Morgan Stanley bid should be especially noted since if the investor group is successful, they may have long sold their interest in Conrail to other as yet unspecified parties. There is nothing wrong with that. That is the business I am in, that is the business Shearson Lehman is in. But clearly the investor group is not offering to be accountable for Conrail's oper-

ations or, for that matter, its financial well being indefinitely into the future.

How about avoiding antitrust problems? Here the Morgan Stanley proposal holds a potential advantage. However, keep in mind we are talking about potential antitrust problems. Though the rail industry has been marked by major mergers, bankruptcy and system abandonments over the past two decades which have greatly reduced the number of rail competitors overall, there is precious little evidence to date of excess profits within the industry.

Returns in the industry on capital and equity are still below corporate averages. Put simply, the degree of concern over antitrust consequences should reflect not only the potential advantage of keeping Conrail independent but also the procompetitive effects of the divestitures agreed to by Norfolk Southern and the fact that there is intense competition from all kinds of sources.

It is quite possible, and I would venture to say even likely, that these factors would prevent Norfolk Southern/Conrail from earning monopoly profits just as they seem to have prevented Conrail from earning monopoly profits in the markets where it is currently dominant.

RETURN TO THE TAXPAYER

This, of course, is a misnomer. What seems to be called for is a price that offsets as much of the taxpayer dollar sunk into Conrail in the past decade while minimizing the chance any more will have to be sent in the same direction. On a cash on the barrel head basis, the bids are dead even assuming none of the Morgan Stanley investors reconsider. Then there is the matter of the extra $600 million of indirect savings to the Government which Morgan Stanley claims its proposal would produce. I cannot make any definitive estimate of these indirect savings—if any—in part because I had neither the time nor the background information needed to verify the estimate or make independent calculations.

First, to the extent that I understand them, they require forecasts of future business tactics, Government policy and economic growth. To use an example, most of Wall Street appears to be coming to the belief that Congress will shortly eliminate the investment tax credit. This, of course, leaves any portion of any additional indirect cost to the Government attributable to Norfolk's ability to benefit from Conrail's future ITC generation at zero.

Another example involves guessing at future business tactics. Morgan Stanley assumes that Norfolk Southern will find ways to shift parent earnings to Conrail and thus more rapidly use tax benefits. The implicit assumption, it seems, is that the management of an independent Conrail would not attempt to use any available tax shields at its disposal more rapidly than they might if they remained totally passive.

That is not a fair comparison. There are always ways to look at to reduce tax liabilities, and I would presume that if Conrail's management was faithful to their stockholders, they would explore every one of them.

The second example is the job issue, and there I do not know what the job impact will be. It is difficult to say. But I am not sure

that it matters a great deal because even if Norfolk Southern managed to get by with a lot fewer people, is getting the job of railroading done in the east with fewer resources bad for the country? It might be bad for the rail retirement fund, but it would be good for shippers and consumers who would get lower rates, good for the Social Security fund. Presumably those who are laid off would find employment elsewhere.

But even if Norfolk Southern managed to get by with so many fewer people, is that bad? Is getting the job of railroading done in the East with fewer resources bad for the country? The answer is no. It might be bad for the rail retirement fund but it would be good for shippers and consumers—who would likely benefit from lower rates—and good for the social security fund as presumably some of those laid off would find employment and pay taxes elsewhere in the economy.

Do you want to allow Conrail to stand alone because you think they will be less efficient than a Norfolk/Conrail combination and employ more excess personnel? If so I predict you will be surprised because an independent, investor-owned Conrail in a hotly competitive industry will face intense pressure to reduce excess employment just as they have done so dramatically in the last 5 years. I see this pressure every day.

In conclusion, I would say this, that if you believe that the $600 million estimate of indirect savings offered by Morgan Stanley is not a soft dollar estimate but equivalent to hard cash; if you believe that despite the evidence of monopoly returns in the rail industry now that there is something different about Norfolk/Conrail that would prove pernicious; if you believe that Morgan Stanley's projections for Conrail's earnings are reasonable and not overly optimistic such that the fear of Conrail doing badly sometime in the future is overdone; and if you believe that the funds committed by Morgan Stanley's investors are guaranteed, then you should give the Morgan Stanley proposal careful consideration.

On the other hand, if you believe that the true value of any of these indirect savings claimed by Morgan Stanley are too small and uncertain to govern the decision on Conrail; if you think that the monopoly profits that people are afraid of are unlikely enough in a Norfolk/Conrail combination with divestitures in truck-rail competition and pure trucking competition, that this should not really govern Conrail's disposition; if you believe, as do apparently both CSX and Norfolk Southern that a two-railroad market in the East may prove inevitable; if you believe that a shrinkage of plant and employment which is part and parcel of a reduction to a two-railroad market in the East is better handled in a planned and orderly consolidation such as the case with the current sale to Norfolk Southern, then I would suggest merging Conrail into the Norfolk Southern system is probably the best choice.

It provides the most secure future for rail service in the Northeast, the best protection for the investment that taxpayers have already made in the Conrail system, and the least likelihood of requests for Government assistance in the future.

Thank you very much.

[The attachments follow:]

This attachment contains seven forecasts for Conrail's earnings and cash flow from 1985 through 1988. The purpose is to begin with Morgan Stanley's forecast (Table I) as a base and make various changes—some minor, some significant—in the assumptions in order to gauge the effects on both reported earnings and cash flow. The addition of more pessimistic (though I believe wholly plausible) assumptions that were used by Morgan Stanley indicate the margin for error—that is the possibility of significant cash deficits all uses of cash being held constant—may be quite thin. The direction of change and general order of magnitude of the results not the precise numbers should be the focus of attention.

Table I Base Case: The Morgan Stanley forecast as presented to financial analysts in New York on May 14, 1985

	1985	1986	1987	1988
Tons	185	191	178	192
Annual chg.		3.2%	-6.8%	7.9%
Revenue	$3294	$3560	$3497	$4056
Annual Chg.		8.1%	-1.8%	16.0%
Revenue per ton	$17.81	$18.64	$19.65	$21.13
Annual chg.		4.7%	5.4%	7.5%
Cost	$2903	$3073	$3233	$3577
Annual chg.		5.9%	5.2%	10.6%
Cost per Ton	$15.69	$16.09	$18.16	$18.63
Annual chg.		2.5%	12.9%	2.6%
Operating Income	$391	$487	$264	$479
Other Pretax income	$ 41	$ 11	$ 9	$ 12
Pre tax income	$432	$498	$273	$491
Tax rate	30.1%	27.5%	12.1%	26.9%
Tax	$130	$137	$ 33	$132
Net income	302	361	240	359
Earnings per share	$10.27	$12.28	$8.16	$12.21
Cash Flow				
Net income	$367	$361	$240	$359
Non Cash Items	276	386	291	394
as percent of Revenue	8.4%	10.8%	8.3%	9.7%
Total Cash	$643	$747	$531	$753
Cash Uses				
Capital Expenditures	$(552)	$(500)	$(500)	$(500)
External Financing	110	75	135	135
Debt Repayment	(130)	(110)	(110)	(115)
Cash Transactions	(37)			
Dividends	(30)	(121)	(121)	(121)
Other Net	$ 50	$ 5	$ (10)	$ (15)
Total	$(927)	$(651)	$(606)	$(616)
Net Cash Flow	$(284)	$ 96	$ (75)	$ 137

Table II Base Case with rail rates flat in 1987, the forecast recession year and rate rebounding 13.3% in 1988.

	1985	1986	1987	1988
Tons	185	191	178	192
Annual chg.		3.2%	-6.8%	7.9%
Revenue	$3294	$3560	$3318	$4056
Annual Chg.		8.1%	-6.8%	22.2%
Revenue per ton	$17.81	$18.64	$18.64	$21.13
Annual chg.		4.7%	0.0%	13.3%
Cost	$2903	$3073	$3233	$3577
Annual chg.		5.6%	5.2%	10.6%
Cost per Ton	$15.69	$16.09	$18.16	$18.63
Annual chg.		2.5%	12.9%	2.6%
Operating Income	$391	$487	$ 85	$479
Other Pretax income	$ 41	$ 11	$ 9	$ 12
Pretax income	$432	$498	$ 94	$491
Tax rate	30.1%	27.5%	12.1%	26.9%
Tax	$130	$137	$ 11	$132
Net income	302	361	83	359

Earnings per share	$10.27	$12.28	$2.81	$12.21
Cash Flow				
Net income	$167	$361	$ 83	$359
Non Cash Items	276	386	291	394
as percent of Revenue	8.4%	10.8%	8.8%	9.7%
Total Cash	$643	$747	$374	$753
Cash Uses				
Capital Expenditures	$(552)	$(500)	$(500)	$(500)
External Financing	110	75	135	135
Debt Repayment	(130)	(110)	(110)	(115)
Cash Transactions	(375)			
Dividends	(30)	(121)	(121)	(121)
Other Net	$ 50	$ 5	$ (10)	$ (15)
Total	$(927)	$(651)	$(606)	$(618)
Net Cash Flow	$(285)	$ 96	$(232)	$ 137

Table III Base Case with flat rail rates in 1987 and Morgan Stanley forecast rate gain of 7.5% 1988 vs 1987.

	1985	1986	1987	1988
Tons	185	191	178	192
Annual chg.		3.2%	-6.8%	7.9%
Revenue	$3294	$3560	$3318	$3848
Annual Chg.		8.1%	-6.8%	16.0%
Revenue per ton	$17.81	$18.64	$18.64	$20.04
Annual chg.		4.7%	0.0%	7.5%
Cost	$2903	$3073	$3233	$3577
Annual chg.		5.9%	5.2%	10.6%
Cost per Ton	$15.69	$16.09	$18.16	$18.63
Annual chg.		2.5%	12.9%	2.6%
Operating Income	$391	$487	$ 85	$271
Other Pretax income	$ 41	$ 11	$ 9	$ 12
Pretax income	$432	$498	$ 94	$283
Tax rate	30.1%	27.5%	12.1%	26.9%
Tax	$130	$137	$ 11	$ 76
Net income	$302	$361	$ 83	$207
Earnings per share	$10.27	$12.28	$2.81	$7.04
Cash Flow				
Net income	$167	$361	$ 83	$207
Non Cash Items	276	386	291	394
as percent of Revenue	8.4%	10.8%	8.9%	10.2%
Total Cash	$643	$747	$374	$601
Cash Uses				
Capital Expenditures	$(552)	$(500)	$(500)	$(500)
External Financing	110	75	135	135
Debt Repayment	(130)	(110)	(110)	(115)
Cash Transactions	(375)			
Dividends	(30)	(121)	(121)	(121)
Other Net	$ 50	$ 5	$ (10)	$ (15)
Total	$(927)	$(651)	$(606)	$(616)
Net Cash Flow	$(284)	$ 96	$(232)	$ (15)

Table IV Base Case with flat rates in 1987 recession, a 3.75% rate gain in 1988 and flat rail unit volume 1988 vs 1987. No additional deterioration in unit costs in 1988 (same 2.5% increase) as a result of no volume growth. i.e. a moderate 2 year recession forecast.

	1985	1986	1987	1988
Tons	185	191	178	178
Annual chg.		3.2%	-6.8%	0.0%

Revenue	$3294	$3560	$3318	$3442
Annual Chg.		8.1%	-6.8%	3.7%
Revenue per ton	$17.81	$18.67	$18.64	$19.34
Annual chg.		4.8%	0.0%	3.7%
Cost	$2903	$3073	$3233	$3315
Annual chg.		5.9%	5.2%	2.5%
Cost per Ton	$15.69	$16.09	$18.16	$18.62
Annual chg.		2.5%	12.9%	2.5%
Operating Income	$391	$487	$ 85	$127
Other Pretax income	$ 41	$ 11	$ 9	$ 12
Pretax income	$432	$498	$ 94	$139
Tax rate	30.1%	27.5%	12.1%	26.9%
Tax	$130	$137	$ 11	$ 37
Net income	$302	$361	$ 83	$102
Earnings per share	$10.27	$12.28	$2.81	$3.46
Cash Flow				
Net income	$367	$361	$ 83	$102
Non Cash Items	276	386	291	394
as percent of Revenue	8.4%	10.8%	8.8%	11.4%
Total Cash	$643	$747	$374	$496
Cash Uses				
Capital Expenditures	$(552)	$(500)	$(500)	$(500)
External Financing	110	75	135	135
Debt Repayment	(130)	(110)	(110)	(115)
Cash Transactions	(375)			
Dividends	(30)	(121)	(121)	(121)
Other Net	$ 50	$ 5	$ (10)	$ (15)
Total	$(927)	$(651)	$(606)	$(616)
Net Cash Flow	$(284)	$ 96	$(232)	$(120)

Table V Base Case (Same as Table I) but with no ITC shelter (i.e. flat 33% tax rate)

	1985	1986	1987	1988
Tons	185	191	178	192
Annual chg.		3.2%	-6.8%	7.9%
Revenue	$3294	$3560	$3497	$4056
Annual Chg.		8.1%	-1.8%	16.0%
Revenue per ton	$17.81	$18.64	$19.65	$21.13
Annual chg.		4.7%	5.4%	7.5%
Cost	$2903	$3073	$3233	$3577
Annual chg.		5.9%	5.2%	10.6%
Cost per Ton	$15.69	$16.09	$18.16	$18.63
Annual chg.		2.5%	12.9%	2.6%
Operating Income	$391	$487	$264	$479
Other Pretax income	$ 41	$ 11	$ 9	$ 12
Pretax income	$432	$498	$273	$491
Tax rate	30.1%	33.0%	33.0%	33.0%
Tax	$130	$164	$ 90	$162
Net income	$302	$334	$183	$329
Earnings per share	$10.27	$11.35	$6.22	$11.19
Cash Flow				
Net income	$367	$334	$183	$329
Non Cash Items	276	386	291	394
as percent of Revenue	8.4%	10.8%	8.3%	9.7%
Total Cash	$643	$720	$474	$723
Cash Uses				
Capital Expenditures	$(552)	$(500)	$(500)	$(500)
External Financing	110	75	135	135
Debt Repayment	(130)	(110)	(110)	(115)
Cash Transactions	(375)			
Dividends	(30)	(121)	(121)	(121)
Other Net	$ 50	$ 5	$ (10)	$ (15)
Total	$(927)	$(651)	$(606)	$(616)
Net Cash Flow	$(284)	$ 69	$(132)	$ 107

Table VI Same assumptions as Table III but with 33% tax rate and no ITC shelter.

	1985	1986	1987	1988
Tons	185	191	178	192
Annual chg.		3.2%	-6.8%	7.9%
Revenue	$3294	$3560	$3318	$3848
Annual Chg.		8.1%	-6.8%	16.0%
Revenue per ton	$17.81	$18.64	$18.64	$20.04
Annual chg.		4.7%	0.0%	7.5%
Cost	$2903	$3073	$3233	$3577
Annual chg.		5.9%	5.2%	10.6%
Cost per Ton	$15.69	$16.09	$18.16	$18.63
Annual chg.		2.5%	12.9%	2.6%
Operating Income	$391	$487	$ 85	$271
Other Pretax income	$ 41	$ 11	$ 9	$ 12
Pretax income	$432	$498	$ 94	$283
Tax rate	30.1%	33.0%	33.0%	33.0%
Tax	$130	$164	$ 31	$ 93
Net income	$302	$334	$ 63	$190
Earnings per share	$10.27	$11.35	$2.14	$6.45
Cash Flow				
Net income	$367	$334	$ 63	$160
Non Cash Items	276	386	291	394
as percent of Revenue	8.4%	10.8%	8.9%	10.2%
Total Cash	$643	$720	$354	$584
Cash Uses				
Capital Expenditures	$(552)	$(500)	$(500)	$(500)
External Financing	110	75	135	135
Debt Repayment	(130)	(110)	(110)	(115)
Cash Transactions	(175)			
Dividends	(30)	(121)	(121)	(121)
Other Net	$ 50	$ 5	$ (10)	$ (15)
Total	$(927)	$(651)	$(606)	$(616)
Net Cash Flow	$(284)	$ 69	$(252)	$ (32)

Table VII Same as Table IV (a moderate two year recession) without ITC, tax rate of 33%.

	1985	1986	1987	1988
Tons	185	191	178	178
Annual chg.		3.2%	-6.8%	0.0%
Revenue	$3294	$3560	$3318	$3442
Annual Chg.		8.1%	-6.8%	3.7%
Revenue per ton	$17.81	$18.64	$18.64	$19.34
Annual chg.		4.7%	0.0%	3.7%
Cost	$2903	$3073	$3233	$3315
Annual chg.		5.9%	5.2%	2.5%
Cost per Ton	$15.69	$16.09	$18.16	$18.62
Annual chg.		2.5%	12.9%	2.5%
Operating Income	$391	$487	$ 85	$127
Other Pretax income	$ 41	$ 11	$ 9	$ 12
Pretax income	$432	$498	$ 94	$139
Tax rate	30.1%	33.0%	33.0%	33.0%
Tax	$130	$164	$ 31	$ 46
Net income	$302	$334	$ 63	$ 93
Earnings per share	$10.27	$11.35	$2.14	$3.17

Cash Flow				
Net Income	$367	$334	$ 63	$ 93
Non Cash Items	276	386	291	394
as percent of Revenue	8.4%	10.8%	8.9%	11.4%
Total Cash	$643	$720	$354	$487
Cash Uses				
Capital Expenditures	$(552)	$(500)	$(500)	$(500)
External Financing	110	75	135	135
Debt Repayment	(130)	(110)	(110)	(115)
Cash Transactions	(375)			
Dividends	(30)	(121)	(121)	(121)
Other Net	$ 50	$ 5	$ (10)	$ (15)
Total	$(927)	$(651)	$(606)	$(616)
Net Cash Flow	$(284)	$ 69	$(252)	$(129)

The CHAIRMAN. Mr. Brody?

Mr. BRODY. Thank you very much, Mr. Chairman.

We have already presented our analysis and our viewpoints.

Morgan Stanley has done a good job of putting together an investment group and they have been eloquent before you today on behalf of themselves and their group. There are many aspects of the presentation which were biased in favor of their group, as their investor group has an opportunity to make a substantial profit if they are successful.

There are many statements that they made, both of judgment and fact, with which we disagree. It is too late in the day to go into detail on each one. I would suggest that the fundamentals are what need to be focused on, and the fundamentals with respect to viability of Conrail are clear. The Morgan Stanley plan, with its high dividend level, will undoubtedly weaken Conrail and increase the risk of long-term failure. The Morgan Stanley plan cannot make the management planned-for capital expenditures and still pay their planned level of dividends.

One last question I would like to address is this seeming paradox between, how can the investors think it is such a good deal while at the same time you can read about Mr. Watkins saying that he believes that Conrail in the long term will fail? And this paradox is answered because the investors are likely to have a much shorter-term orientation than the long-term viability of Conrail would call for. So long as the short term prospects for Conrail are reasonable and they have the downside price protection for the stock of a high dividend rate, they have a deal that can look very good from a short-term investment perspective.

Thank you.

[The attachment referred to follows:]

Goldman, Sachs & Co. | 85 Broad Street | New York, New York 10004
Tel: 212-902-6102

Howard A. Silverstein
Partner

Goldman Sachs

June 12, 1985

The Honorable Elizabeth H. Dole
Secretary of Transportation
United States Department of Transportation
400 Seventh Street, S.W.
Washington, D.C. 20590

Dear Madam Secretary:

You have asked us as your financial advisor to review the Morgan Stanley Proposal, dated May 14, 1985, as amended on June 7, 1985, to purchase the U.S. Government's 85% interest in Conrail (the "Morgan Stanley Proposal") and to compare the Morgan Stanley Proposal with the transaction contemplated by the Memorandum of Intent, dated February 8, 1985, which you executed with Norfolk Southern Corporation (the "Norfolk Southern Proposal"). In connection with our review, we have, among other things, had discussions regarding Conrail with representatives of the Railway Labor Executives' Association, the Department of Transportation, the Department of Treasury and Norfolk Southern Corporation, analyzed the Morgan Stanley Proposal and discussed it with Morgan Stanley. We also have had discussions with Conrail management concerning Conrail's results of operations through May 1985 and have read the latest Five-Year Outlook for the years 1985-1989 released by Conrail on June 7, 1985.

This letter addresses the financial aspects of the Morgan Stanley and Norfolk Southern Proposals including the effects on Conrail's financial strength, the financial return to the U.S. Government and feasibility and risks of non-consummation. We have not addressed certain labor issues because final agreements among the parties have not been reached, and we have not addressed competitive issues because they have been evaluated by the Department of Justice.

Any analysis of the financial viability of Conrail depends on Conrail's future performance and behavior. Numerous sets of projections of Conrail's financial performance covering comparable periods have been prepared by Conrail's management, the United States Railway Association and Morgan Stanley. There are significant differences in these forecasts. We have not relied upon any single set of forecasts for our analysis, but have based our analysis on the best available information.

Summary of Significant Differences Between the Morgan Stanley and Norfolk Southern Proposals

The Morgan Stanley Proposal is patterned in many respects on the Norfolk Southern Proposal, but there are also a number of material differences, of which the following are especially noteworthy:

1. **Purchasers.** The Morgan Stanley Proposal contemplates that a group of approximately 32 corporations, institutions and individual investors (the "Purchasers") would purchase Conrail's common stock from the U.S. Government pursuant to individual contracts between the U.S. Government and each Purchaser. The Morgan Stanley Proposal contemplates that the Purchasers would begin resales of the Conrail common stock through one or more public offerings beginning as soon as practicable following the purchase from the U.S. Government. The Norfolk Southern Proposal, by contrast, contemplates an acquisition of Conrail's common stock by a single purchaser with a commitment not to resell for five years.

2. **Cash and Other Consideration.** Both proposals call for the payment to the U.S. Government of $1.2 billion in cash plus Conrail's "Excess Cash" (calculated according to a formula which is the same in both cases) in return for the U.S. Government's Conrail common stock and the cancellation of Conrail's debt and preferred stock held by the U.S. Government. The Morgan Stanley Proposal also calls for the issuance to the U.S. Government of Conrail warrants to purchase 1,000,000 shares of Conrail common stock at a per share price of $48, which is equal to the per share price to be paid to the U.S. Government for its common stock.

3. **Conditions to Closing.** Unlike the Norfolk Southern Proposal, the Morgan Stanley Proposal: (i) requires a special exemption from Section 16(b) of the Securities Exchange Act of 1934 (the "short-swing profit" rule) as a condition to the Purchasers' obligation, (ii) excuses performance by each Purchaser if any one of their number defaults on its obligation, (iii) gives the Purchasers termination rights in the event of certain material downturns in the securities markets (the Norfolk Southern Proposal would permit termination only in the event of a material adverse change to Conrail), and (iv) requires that a registration statement under the Securities Act of 1933 be filed before definitive agreements of sale are signed and that the registration statement have become effective before the Closing may occur.

4. **Protective Covenants.** The Morgan Stanley Proposal would permit Conrail to repurchase its common stock from beneficiaries of Conrail's ESOP and would allow Conrail to repurchase the U.S. Government's warrants (or the underlying warrant shares) as exceptions to the covenant that requires cumulative post-closing distributions to common shareholders not to exceed 40% of Conrail's cumulative post-closing net income. Furthermore, the Morgan Stanley Proposal would permit Conrail to pay regular dividends (subject to an unspecified maximum) in the first two quarters following the Closing as an exception to the 40% of net income limit. The Norfolk Southern Proposal does not contain these exceptions. Norfolk Southern has stated in testimony by its Chief Executive Officer, Robert B. Claytor, before the Senate Committee on Commerce, Science and Transportation and the House Subcommittee on Commerce, Transportation and Tourism that none of Conrail's cash or other assets will be used to fund the $375 million in payments to Conrail's employees (agreement and non-agreement) for employee interests and claims and has confirmed to us that such a provision would be included in the definitive agreement of sale reflecting its employee arrangements.

5. **Governance and Control.** Under the Morgan Stanley Proposal, the Purchasers would agree to form a committee which would determine when, and at what price, resales would be effected, to impose restrictions on transfer among the Purchasers and to establish a voting agreement designed to ensure labor and management representation on Conrail's Board of Directors. During the five years following the Closing, no Purchaser owning less than 10% of Conrail's common stock could increase its ownership above 10% and no Purchaser owning more than 10% could acquire any additional shares; thereafter, no individual Purchaser could own more than 10% and the Purchasers as a group could own no more than 40% of the common stock. Morgan Stanley has also orally informed us of its intent to propose legislation and an amendment to Conrail's charter which would prohibit any Conrail shareholder from owning more than 10% of Conrail's common stock during the five years following the Closing.

6. **Other Differences.** The Norfolk Southern Proposal contemplates a $375 million payment to Conrail's present and former employees by Norfolk Southern in satisfaction of all wage claims and in order to purchase the interests of Conrail's ESOP. As discussed above, the Norfolk Southern Proposal would fund this amount entirely from Norfolk Southern's assets rather than Conrail's. The Morgan Stanley Proposal would cause Conrail to distribute $230 million of its cash to employees in settlement of wage claims. Conrail's ESOP would be retained and an undetermined amount (currently estimated by Morgan Stanley to be $70 million) would be made available to permit Conrail to repurchase common stock held by the ESOP. The Morgan Stanley Proposal does not require the U.S. Government to warrant that Conrail's tax basis will be unaffected by the sale, while such warranties are required by the Norfolk Southern Proposal.

Financial Viability of Conrail

A fundamental issue is the long-term viability of Conrail. Mr. Hays Watkins, Chief Executive Officer of CSX Corporation, put the risk most forcefully in his letter to you dated June 13, 1984 in which he unequivocably stated that "Conrail will fail." Since that time, Conrail's results of operations have demonstrated both a decline in tonnage and below-budget earnings. Specifically, for the fourth quarter of 1984 and the first quarter of 1985, Conrail's traffic, expressed in tonnage, has been both below the results for the comparable prior year periods and also below budget. Conrail's operating income for the first quarter of 1985 was approximately 30% below budget and also below the comparable prior period. While this concern about viability will have an impact upon the stock price, it is not likely to preclude the public offering of Conrail common stock contemplated by the Morgan Stanley Proposal given the attractive dividend features of that proposal.

Conrail's recent results highlight the continuation of the long-term trend of steady losses in traffic and the ever-present competitive forces created by trucking companies which Conrail faces in its market area. Conrail has done a commendable job over the past few years in using the special benefits conferred by Congress to manage its business and reduce costs. However, the benefits of its cost improvements have most likely already been substantially realized. The continuing erosion of the traffic base coupled with the fact that Conrail cannot "shrink" its way to prosperity cause us to be concerned that there is a greater than normal risk that Conrail will face an extremely doubtful future. It is important to note that Conrail does not have substantial non-railroad assets, such as real estate and other natural resources that virtually all the other major railroads have, to weather adverse economic times.

The Morgan Stanley Proposal increases the concern over Conrail's viability because it is driven by the dividends to be paid on the common stock which will act as a drain on Conrail's financial strength. The $121 million planned annual dividend is similar to that contemplated by the January management proposal. To satisfy the need for the substantial dividends, it appears to be the intent of the Morgan Stanley Proposal to reduce capital expenditures to an amount which is $469 million less than the amounts called for by Conrail management's June 1985 projections for the years 1986 to 1988. Under Conrail's latest projections, the covenants would not allow both the annual payment of $121 million of dividends on common stock planned by the Morgan Stanley Proposal and the level of capital expenditures recently projected by Conrail's management.

On the other hand, the Norfolk Southern Proposal adds financial strength to Conrail. Norfolk Southern in June 1982 combined the Norfolk and Western Railway and the Southern Railway into an 18,000 mile network. In the past few years, Norfolk Southern's management has successfully consolidated the operations and management of the two railroads into an efficient and strong combined company. A major portion of Norfolk Southern's business strength is a result of its strong coal business which is likely to remain substantial in the foreseeable future. At year-end 1984, Norfolk Southern had $4.5 billion of equity and total assets of $9.9 billion. Norfolk Southern also has exhibited the ability to size and use its plant efficiently and to control labor costs. Norfolk Southern generally has ranked first or second among major railroads with regard to operating margins and return on investment. More importantly, Norfolk Southern has demonstrated a consistent ability to operate a profitable railroad, having earned more than $350 million in each of the last five years and well over $400 million in every year except 1983.

In addition, the combination of Norfolk Southern and Conrail is likely to produce significant additional income. In a planning/information report dated January 5, 1983, Conrail estimated that the combination of Conrail and Norfolk Southern would increase annual pre-tax income by approximately $80 million plus the amount of any additional cost reductions which could be achieved in the area of rationalizing facilities, consolidating traffic flows and integrating other functions. In addition, in times of adversity, Norfolk Southern is more likely than the capital markets to support Conrail because of: (a) its familiarity with Conrail and its better ability to assess and deal with risks, (b) its commitment to the transportation business over the long term, and (c) its substantial financial resources. In our view, Norfolk Southern brings to Conrail a substantially higher degree of financial strength than Conrail can achieve under the Morgan Stanley Proposal.

Financial Return to the U.S. Government

Each of the two proposals offers $1.2 billion in cash plus the excess cash over $800 million as determined by formula. Assuming a Closing on December 31, 1985 and using Conrail's latest financial plan, the excess cash is estimated to be approximately $75 million. The total cash consideration under both proposals would therefore be approximately $1.275 billion.

As mentioned before, the Morgan Stanley Proposal calls for the issuance of warrants to the U.S. Government. The value of the warrants under the Morgan Stanley Proposal as of the time of Closing will not be substantial relative to the purchase price, and this value is highly dependent upon the actual public market value of Conrail common stock. If the fully-distributed market value of 100% of the common stock of Conrail were approximately $1.6 billion, then the warrants would have an approximate value of $16 million. Even if the fully-distributed market value were $2.0 billion as suggested by a Morgan Stanley brochure prepared for investors, the warrants would still be worth only approximately $27 million.

Another element of the financial return to the U.S. Government is the difference in the present value of tax revenues to be received under the two proposals. Whereas the cash received is a hard number and the value of the warrants can be estimated within reason, the value of the tax revenue differences is much more difficult to estimate and therefore much less reliable. The tax numbers are difficult to estimate because they are dependent upon a large number of future events, including Conrail income and capital expenditures, Norfolk Southern income, Conrail's actions as an independent entity with respect to leasing and other tax transference mechanisms, Norfolk Southern's ability and/or willingness to make use of Conrail deductions, and, to a very large degree, any changes in the tax code. In addition, assumptions about the behavior of the economy as a whole need to be made.

We have relied upon our outside advisors, namely Coopers & Lybrand, Hughes Hubbard & Reed, and Sullivan & Cromwell, for the preparation of the tax revenue analysis. We have reviewed with Morgan Stanley the tax analysis presented by them and have concluded that such analysis is substantially and unreasonably biased in favor of their proposal. For example, the Morgan Stanley Proposal uses the lower Conrail management income projections prepared in June 1984 for tax purposes rather than the higher estimates that the Morgan Stanley Proposal relies upon in the same document for its viability analysis, with the effect of substantially increasing the tax revenue differential. Their analysis also ignores the tax revenue loss from tax benefits taken by third parties entering into leasing transactions with a stand-alone Conrail.

Our analysis includes the following conservative assumptions which we believe tend to overstate the tax revenue differential: (a) Norfolk Southern's income is sufficiently high to permit full and immediate utilization of Conrail tax benefits as they accrue, (b) Norfolk Southern's utilization of Conrail's tax benefits is not restricted by the tax laws, (c) tax reduction transactions that Norfolk Southern might undertake were it not to acquire Conrail have not been taken into account, and (d) other than a conservative estimate of Conrail leasing activity, no other tax benefit transfer transactions, such as the acquisition of profitable companies, by a stand-alone Conrail have been taken into account.

Our analysis indicates that the tax revenue over time is identical under the two proposals, but that, on a present value basis, the tax return to the U.S. Government under the Morgan Stanley Proposal is approximately $30 million greater than under the Norfolk Southern Proposal, utilizing the Morgan Stanley Proposal's projections for Conrail income. Although we have not had the opportunity to review thoroughly Conrail's new five-year forecast released on June 7, 1985, we estimate that the differential would increase using those projections, but would still be significantly below $100 million. Under the President's tax reform proposal, our analysis estimates that the differential between the two proposals would be eliminated entirely. Our analysis has not taken into account payments that might arise from a labor settlement, the magnitude and deductibility of which are presently uncertain. Our preliminary view is that any such payments are likely to increase the tax revenue differential in the range of $30 to $50 million.

Perhaps the most important item to note with regard to this analysis is that the net tax revenue loss associated with the Norfolk Southern Proposal increases as Conrail income declines, but this is precisely the time when Conrail's long-term viability is threatened and Norfolk Southern's financial backing is critical.

The other aspect of tax impact which we reviewed was the Morgan Stanley Proposal's estimate of a $245 million reduction in Railroad Retirement (Tier 2) and Unemployment Tax revenues. Our preliminary conclusion is that this putative reduction is factually unsubstantiated and does not represent an absolute revenue loss of any amount to the U.S. Government. The Morgan Stanley Proposal's estimate is based on a speculative projection of 10,000 job losses which contradicts prior estimates and ignores job shifting among railroads. Further, it ignores the increased employment tax revenues to other single purpose funds, such as the Social Security system, that will result from employment of terminated railroad workers in other job sectors. For these reasons, we believe it is inappropriate to assign any revenue differential value to this item. We express no view on the theoretical question of whether a reduction in contributions to a single purpose trust in the absence of a deficit resulting in contributions from general revenues should be regarded as a revenue loss.

We have not added the numbers from cash proceeds, warrant value and tax differentials together because to do so would be misleading. The quality of the numbers is substantially different and as a practical matter both the value of the warrants and, to a much larger degree, the value of the tax differentials should be discounted due to the uncertainty regarding their realization.

Feasibility of Proposal and Risks of Non-Consummation

For a number of reasons, the Morgan Stanley Proposal presents greater risks of non-consummation than does the Norfolk Southern Proposal. The following paragraphs discuss the more significant of these risks.

We are concerned that the Purchasers under the Morgan Stanley Proposal will not sign definitive agreements with the U.S. Government in the first instance unless market conditions appeared likely to permit profitable resales to begin immediately following the Closing. Norfolk Southern's interest is long-term, and we believe that Norfolk Southern's decision to proceed with definitive agreements would not be significantly altered by temporary fluctuations in the securities markets. The Morgan Stanley Proposal contemplates that a registration statement covering resales will be filed before such definitive agreements are signed; assuming that the agreements are signed, it is a condition to the Purchasers' obligations to complete the transaction that the registration statement have become effective. The requirement for an effective registration statement as a precondition to Closing raises timing issues, since we believe that it would take approximately two months from the date of Congressional action before the registration statement could be declared effective.

The Purchasers' commitment is conditioned upon obtaining a special legislative exemption from Section 16(b) of the Securities Exchange Act of 1934, in order to permit the Purchasers as possible "insiders" to retain "short-swing" profits resulting from sales of Conrail common stock within the six months following the Closing. In addition, as described earlier, the Morgan Stanley Proposal conditions the obligation of the Purchasers upon the absence of a default by any Purchaser and upon the absence of any calamity or crisis, the effect of which upon the securities markets is such as to make it (in Morgan Stanley's judgment) impracticable to proceed.

Finally, if the U.S. Government were to give serious consideration to the Morgan Stanley Proposal, extensive negotiations would be required with respect to many terms of that proposal. No such negotiations have yet taken place, and the substantive changes resulting from such negotiations and the timing of the negotiations could adversely affect the continued willingness of the Purchasers to proceed. By contrast, all of the principal terms of the Norfolk Southern Proposal have been agreed upon and are reflected in the Memorandum of Intent.

Conclusions

In our view, the Morgan Stanley Proposal, as contrasted with the Norfolk Southern Proposal, offers the potential of a somewhat higher financial return while it substantially reduces the financial strength of Conrail and somewhat increases the risk of non-consummation. As you have stated and as we have advised you, there has always been a trade-off between the financial return the U.S. Government could achieve in the sale of Conrail and the resulting financial strength of Conrail. The degree of risk regarding the viability of Conrail that the U.S. Government is willing to assume and the consequences of maintaining or discontinuing the status quo of Conrail as an independent entity are matters of public policy to be resolved by the U.S. Government.

We recognize that you have considered a number of proposals calling for the retention of Conrail as an independent entity and the sale of Conrail's common stock in public offerings and that you have concluded that such proposals do not comport with NERSA's primary goal of ensuring Conrail's future financial strength. However, if the U.S. Congress were to decide in favor of maintaining Conrail as an independent entity, it is our judgment that the Morgan Stanley Proposal is not an attractive alternative. The risk/return relationship is unduly weighted in favor of the Purchasers at the expense of the financial strength of Conrail and the financial return to the U.S. Government. The financial risk borne by the Purchasers is quite limited as they have the benefit of high dividends in addition to the ability not to consummate the transaction if conditions deteriorate significantly. Furthermore, the Purchasers stand to reap virtually all of the potential gain in the appreciation, if any, of the Conrail common stock. Therefore, if Congress were to decide in favor of maintaining Conrail as an independent entity, it is our recommendation that the U.S. Government consider seriously the alternatives to the Morgan Stanley Proposal.

Very truly yours,

GOLDMAN, SACHS & CO.

EXHIBIT 1.—CONRAIL

CLOSING COMMON STOCK PRICES OF SELECTED RAILROADS

	Norfolk Southern	Burlington Northern	CSX Corp	Santa Fe Southern Pacific	Union Pacific
January 24, 1985 [1]	$65.38	$55.00	$25.88	$27.13	$46.50
June 7, 1985	$68.63	$58.00	$25.75	$30.13	$48.88
Percent change	5.0	5.5	(0.5)	11.1	5.1

[1] Date of Goldman Sachs' letter to Secretary Dole analyzing Management's January, 1984 public offering proposal.

Exhibit 2

COMMON STOCK COMPARISON OF SELECTED RAILROADS
(CONT'D)

	NORFOLK SOUTHERN CORP. (12/31/84)	BURLINGTON NORTHERN INC. (12/31/84)	CSX CORP. (12/31/84)	SANTA FE SOUTHERN PACIFIC CP (12/31/84)	UNION PACIFIC CORP. (12/31/84)
		(Dollars in Millions)			(Dollars in Millions)
Capitalization					
Short Term Debt	$ 157.7 2.9%	$ 151.8 2.1%	$ 391.0 3.0%	$ 180.0 2.4%	$ 307.0 4.4%
Long Term Debt	837.4 15.8	3,413.9 48.4	5,340.0 40.6	1,844.0 24.9	1,884.0 27.0
Preferred Stock (Liq. Val)	0.0 0.0	100.0 1.4	0.0 0.0	0.0 0.0	174.0 2.5
Common Equity	4,472.1 81.3	3,377.1 47.9	6,399.0 48.6	5,398.0 72.7	4,773.0 68.5
Total Capitalization	$ 5,467.2 100.0%	$ 7,042.9 100.0%	$ 13,130.0 100.0%	$ 7,422.0 100.0%	$ 6,792.0 100.0%
Common Shares Outstanding	82,423,000	72,000,000	185,163,000	75,133,000	112,783,000
Cash & Equiv/Total Mkt. Val	11.85% 16.1/47	10.1 16.1/4.5	17.1 12.8/11.5	30.1 16.1/9.1	10.0 15.1/11.1
Pre Tax/Net Int/Net Margin	3 Yrs. Ended 12/31/84	3 Yrs. Ended 12/31/84	3 Yrs. Ended 12/31/84	3 Yrs. Ended 12/31/84	3 Yrs. Ended 12/31/84
Earned Fixed Chg.	$ 3.5x 3.0x 14.0%	$ 2.6x 2.0x 4.0%	$ 2.6x 2.0x 7.1%	$ 3.0x 2.0x 8.1%	$ 4.8x 3.0x 3.1%
	3.2x 2.6x 11.6	3.1x 2.0x 7.4	3.1x 2.0x 6.5	4.2x 2.0x 7.6	6.6x 3.0x 3.3
	3.1x 2.6x 11.2	4.1x 2.0x 8.6	4.0x 2.0x 6.5	5.1x 2.0x 9.7	5.6x 3.0x 4.9
	3.1x 2.6x 11.3	4.0x 2.0x 9.1	3.8x 2.0x 6.8	4.6x 2.0x 9.1	6.1x 3.0x 3.1
Latest Fiscal Year	3.1x 2.6x 11.3	4.1x 2.0x 9.1	3.8x 2.0x 6.8	4.6x 2.0x 9.1	6.1x 3.0x 3.1
Compound Growth/Avg Mar.	3.1x 2.6x 11.3	4.1x 2.0x 9.1	3.8x 2.0x 6.8	4.6x 2.0x 9.1	6.1x 3.0x 3.1
	1.5% 0.5% 12.5%	16.1% 15.6% 7.7%	11.1% 7.9% 6.9%	1.6% % 6.5%	13.8% 3.6% 8.7%
EPS/Fixed Chg/Payout Ratio					
Earned Fixed Trend	$ 7.91 $ 2.10 13%	$ 5.11 $ 4.19 19%	$ 5.91 $ 4.61 19%	$ 2.96 $ 2.01 13%	$ 9.51 $ 5.45 12%
	8.38 2.60 11	4.28 3.77 18	5.71 4.46 19	3.18 2.61 14	8.71 5.01 11
	7.15 3.76 15	3.77 3.74 19	5.19 4.35 19	3.45 2.64 15	3.78 2.90 10
	5.87 3.98 18	3.68 3.47 21	5.67 4.38 18	3.77 2.68 16	3.37 2.38 10
Latest Fiscal Year	7.68 2.59 15	7.71 1.99 21	5.72 4.44 22	3.45 2.68 16	4.80 2.80 11
Latest 12 Months	7.84 2.51 15	7.18 1.98 21	5.90 4.41 21	2.38 1.66 10	6.12 3.99 16
Most Yr Earned Fixed Ratio	7.84 2.51 15	9.41 1.98 21	5.90 4.41 21	3.68 2.66 10	6.12 3.99 16
5 Yr Growth Rate Fixed/Avg Pay	8.3% 9.3% 2.6%	8.3% 14.7% 17%	1.9% 13.7% 13%	% 2.3% 3%	3.1% 6.9% 6%
Interim EPS (Thru 3/31/xx, Vs)	3 Months Mar.	3 Months Mar.	3 Months Mar.	3 Months Mar.	3 Months Mar.
	1.15 1.14	0.95 0.95	0.61 0.75	0.59 0.54	0.55 0.61
Market Range Calendar Yr	83/82	83/82	83/82	83/82	83/82
1982	$ 44.75 $ 29.38	$ 50.00 $ 35.00	$ 38.75 $ 24.63	$ 34.63 $ 20.38	$ 53.75 $ 31.25
1981	48.63 37.75	38.25 30.13	31.25 25.63	31.25 24.00	55.88 39.13
83/82	34.01%	38.9%	35.7%	38.1%	48.6%
PE Ratio					
1983	8.5x 6.5x	7.0x 4.9x	8.0x 5.6x	14.0x 7.0x	11.5x 8.1x
1981	8.7 7.6	8.3 6.0	8.0 7.3	13.1 10.3	11.7 8.6
Latest 3 Month EPS	8.9	8.1	8.7	11.6	11.8
Next 12 EPS Est	8.7	7.8	7.3	11.3	10.8
Book Value/Shr as % Mkt	81.0% 86.6%	64.0% 50.3%	62.9% 78.0%	83.0% 83.0%	82.1% 146.0%
Dividend Yield	3.9%	3.3%	3.3%	3.3%	3.7%

DEFINITIONS AND CONVENTIONS:

SHORT TERM DEBT: All indebtedness for borrowed money due within one year including current maturities of long term debt.

LONG TERM DEBT: All indebtedness for borrowed money including capitalized lease obligations but excluding current maturities of long term debt.

COMMON EQUITY: Total stockholders' equity less involuntary liquidation value of preferred stock.

COMMON SHARES OUTSTANDING: At the date of capitalization data, adjusted for any subsequent splits, number of shares issued less shares held in treasury, rounded to nearest thousand shares.

CASH: Total cash and marketable securities included in current assets.

TOTAL MARKET VALUE: Average number of shares outstanding for most recent interim period used in calculating primary earnings per share multiplied by most recent common stock price as printed in report.

NET INCOME: From continuing operations, before extraordinary items, as restated.

PRIMARY EARNINGS PER SHARE: From continuing operations, before extraordinary items, as restated and adjusted for splits.

FULLY DILUTED EARNINGS PER SHARE: From continuing operations, before extraordinary items, as originally reported (i.e. not restated) but adjusted for splits.

PAYOUT RATIO: Dividends declared on common shares divided by net income applicable to common shares.

MARKET RANGE: High and low market price per share during indicated calendar year; all prices are split adjusted.

PRICE/EARNINGS RATIO: Historical range is based upon price ranges as described above and earnings per share for the corresponding calendar year; earnings per share are split adjusted, but not restated.

BOOK VALUE: Common equity divided by common shares outstanding, at capitalization table date.

TANGIBLE BOOK VALUE: Common equity less intangibles divided by common shares outstanding at capitalization table date.

DIVIDEND YIELD: Indicated annual dividend divided by most recent stock price as printed in report.

ASSET TURNOVER (AVG.): Most recent fiscal year's sales divided by the average of total assets at the last two fiscal year ends.

RETURN ON ASSETS (AVG.): Most recent fiscal year's net income divided by average of total assets at the last two fiscal year ends.

TOTAL LEVERAGE (AVG.): Average of total assets at the last two fiscal year ends divided by average of stockholders' equity at the last two fiscal year ends.

RETURN ON EQUITY (AVG.): Most recent fiscal year's net income divided by average of stockholders' equity at the last two fiscal year ends.

FOOTNOTES:

NORFOLK SOUTHERN CORP:

No applicable footnotes.

BURLINGTON NORTHERN INC:

Earnings are stated before discontinued operations of $105.8 million or $1.00 per share in 1982.

CSX CORP:

No applicable footnotes.

SANTA FE SOUTHERN PACIFIC CP:

Earnings are stated before discontinued operations of $ 6.1 million or $ .08 per share in 1982.
Earnings are stated before discontinued operations of $408.2 million or $ 5.00 per share in 1983.

UNION PACIFIC CORP:

Earnings are stated before discontinued operations of $-144.6 million or $-1.00 per share in 1983.

EXHIBIT 3.—VALUATION OF WARRANTS

Dividend yield on common stock	Common stock price		
	$50.00	$54.03	$67.15
5½ percent	$16.37	$18.93	$27.58
8½ percent	12.03	14.27	22.69

Notes:
Valuation is based on the Cox-Ross-Rubenstein implementation of the Black-Scholes option pricing model.
Common stock prices of $54.03 and $67.15 equate to fully-distributed market values of Conrail of $1.6 billion and $2.0 billion, respectively.
The terms of the warrant are as specified in the Morgan Stanley Proposal.
The ten-year interest rate used in the model is 10½ percent and the volatility factor is 28. The value of 28 is at the high end of the volatility range relative to other railroad stocks; however, this results in higher warrant values, everything else being equal.

Exhibit 4

ANNUAL FREIGHT TONNAGE

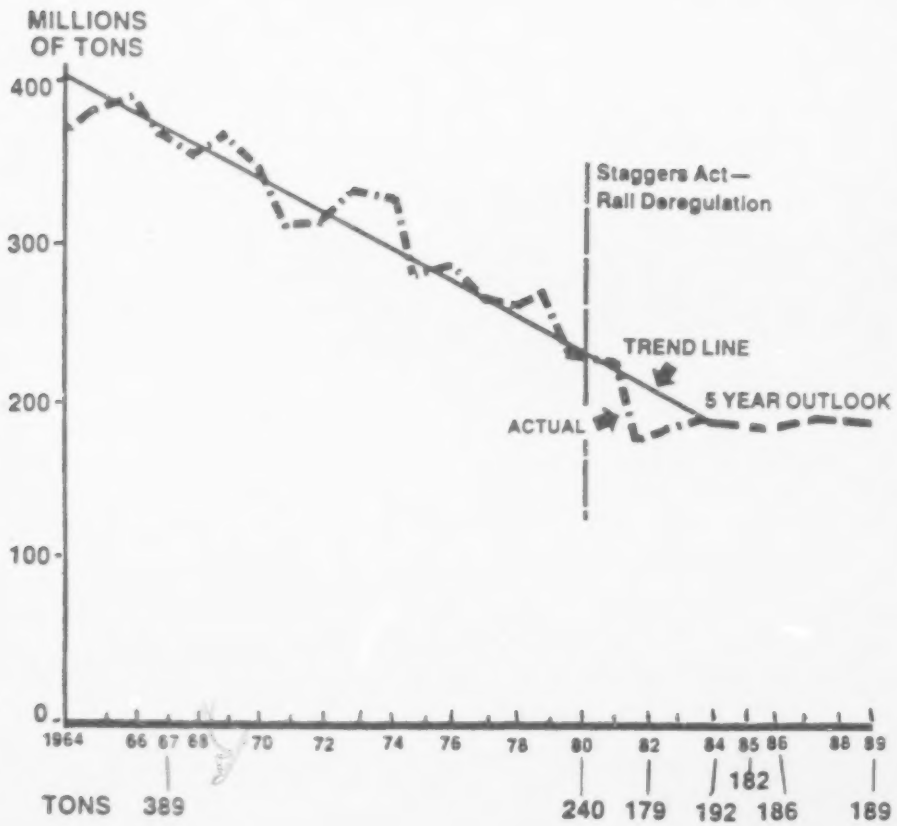

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EXHIBIT 5.—QUOTES FROM THE CSX LETTER: DATED, JUNE 13, 1984

"DECLINE OF NORTHEAST U.S. RAIL POTENTIAL"

"First and foremost is our belief that the Northeast area will not long support three major, duplicative rail systems in good financial health. Conrail has recently reported good earnings associated with the general economic recovery. However, Conrail remains untested over a full turn of the business cycle, let alone several such turns. Its recent earnings must be seen as a short-term aberration that will almost surely disappear once Conrail loses the benefits of Government financing and the special advantages it has enjoyed under Government ownership. Conrail's current returns will be subject to further erosion as it, and the other carriers in the region, must face the realities of an ever-declining Northeastern rail market. This is a problem that has long been recognized and will persist far into the future. It is not a management problem. Conrail's present able management has made significant improvements in Conrail's cost structure, but future cost improvements are limited while the deterioration of Conrail's revenue base unfortunately does not have such limits." (p. 3)

"In our opinion, the most optimistic forecast of growth in total traffic for all modes for the Conrail area would be about 2.8% annually. This number could be considerably lower if there is any recession. The picture becomes even less promising for the region when we focus specifically on rail traffic alone. Here, our forecast indicates a 1% annual increase." (p. 4)

"In short, Conrail's traffic base is eroding. Its ton miles probably will be lower three or five years from now than they are today, just as they are lower today than they were five years ago." (p. 4)

"The business cycle will produce a recession at some point, and the market will only support two carriers. Because of Conrail's particular vulnerability to truck diversion, its lack of significant coal reserves, and the lack of a strong parent, an independent Conrail will be the carrier to fail, causing turmoil in its region and adversely affecting carriers such as CSX who share so much traffic with Conrail." (p. 4)

EXHIBIT 6.—SELECTED QUARTERLY INFORMATION

[Dollars in millions]

	3d quarter			4th quarter			1st quarter		
	Adjusted 1983	1984	Budget 1984	Adjusted 1983	1984	Budget 1984	Adjusted 1984	1985	Budget 1985
Carloadings	728	778	755	762	701	691	784	707	755
Tonnage	46	49	49	48	43	44	49	44	47
Revenue	$747	$828	$830	$794	$782	$795	$841	$789	$840
Reported operating income	81	136	119	97	56	78	85	46	67
Wage adjustments [1]	(30)	[3](30)	(30)	(30)	[3] 30	(30)	(30)		
Adjusted operating income	51	106	89	67	86	48	55	46	67
Reported net income:									
Minus wage adjustments	$56	$111	$89	$88	$119	$49	$61	$55	$92
Tax adjustments [2]	(7)	(7)	(7)	(7)	(7)	(7)	(7)		
Adjusted net income	49	104	82	81	112	42	54	55	92

[1] Adjusted to assume industry wage scale: approximately $30 million/quarter
[2] Adjusted for state taxes: approximately $8 million/quarter
[3] Wage expense accruals were for two quarters during this perid

EXHIBIT 7.—COMPARISON OF SELECTED FORECASTS: CONRAIL MANAGEMENT'S JUNE 1984, USRA'S, MORGAN STANLEY'S MAY 1985 AND CONRAIL MANAGEMENT'S JUNE 1985

[Dollars in millions]

	1985	1986	1987	1988	1989
Tonnage:					
Conrail June 1984	191	175	178	192	
USRA	191	175	178	192	
Morgan Stanley May 1985	185	191	178	192	

EXHIBIT 7.—COMPARISON OF SELECTED FORECASTS: CONRAIL MANAGEMENT'S JUNE 1984, USRA'S, MORGAN STANLEY'S MAY 1985 AND CONRAIL MANAGEMENT'S JUNE 1985—Continued

[Dollars in millions]

	1985	1986	1987	1988	1989
Conrail June 1985	182	186	190	190	189
Revenues:					
Conrail June 1984	$3,404	$3,266	$3,497	$4,056	.....
USRA	3,404	3,266	3,497	4,056	.....
Morgan Stanley May 1985	3,294	3,560	3,497	4,056	.....
Conrail June 1985	3,206	3,371	3,541	3,688	$3,809
Pre-tax income:					
Conrail June 1984	438	216	259	446	.....
USRA	428	207	262	459	.....
Morgan Stanley May 1985	432	498	273	491	.....
Conrail June 1985	457	436	491	528	548
Capital expenditures:					
Conrail June 1984	557	408	548	772	.....
USRA	557	415	556	781	.....
Morgan Stanley May 1985	552	500	500	500	.....
Conrail June 1985	559	634	657	678	665
External equipment financing:					
Conrail June 1984	137	85	199	275	.....
USRA	137	85	199	275	.....
Morgan Stanley May 1985	110	75	135	135	.....
Conrail June 1985	114	146	167	161	145
Debt repayments:					
Conrail June 1984	123	112	119	132	.....
USRA	130	112	119	132	.....
Morgan Stanley May 1985	130	110	110	115	.....
Conrail June 1985	130	132	137	141	145

EXHIBIT 8.—SELECTED PRO FORMA INFORMATION

The pro forma financial information included in this exhibit has been prepared using the assumptions which are attached following the exhibits.

Pro formas based on Conrail Management's June 1984 Projections

Norfolk Southern Proposal—no dividends paid to Norfolk Southern.

Norfolk Southern Proposal—maximum dividends paid by Conrail to Norfolk Southern.

Morgan Stanley May 1985 Proposal.

Pro formas based on Morgan Stanley May 1985 Projections

Norfolk Southern Proposal—no dividends paid to Norfolk Southern.

Norfolk Southern Proposal—maximum dividends paid by Conrail to Norfolk Southern.

Morgan Stanley May 1985 Proposal.

Pro formas based on Conrail Management's June 7, 1985 Projections

Norfolk Southern Proposal—maximum dividends paid by Conrail to Norfolk Southern.

Morgan Stanley May 1985 Proposal.

PRO FORMA CAPITALIZATION ASSUMING PUSH-DOWN ACCOUNTING, DECEMBER 31, 1985

[Dollars in millions]

	Morgan Stanley proposal Conrail		Norfolk Southern Proposal [1]			
			Conrail		Consolidated	
	Dollars	Percent	Dollars	Percent	Dollars	Percent
Long-term debt	852	40.2	852	40.1	3,013	40.3
Common stock	1,270	59.8	1,275	59.9	4,472	59.7
Total	2,122	100.0	2,127	100.0	7,485	100.0

[1] See attached summary of assumptions regarding Norfolk Southern Proposal especially assumptions concerning labor package.

The following information illustrates the level of net income for Conrail and consolidated Conrail/Norfolk Southern assuming different forecasts and proposals.

SUMMARY PRO FORMA NET INCOME

[Dollars in millions]

	1986	1987	1988	1989
Forecast: Conrail June 1984 5-Year Plan:				
Consolidated Norfolk Southern/Conrail	$772	$851	$1,058	
Conrail	344	408	600	
Consolidated Norfolk Southern/Conrail	772	840	1,044	
Conrail (paying dividends)	344	397	586	
Conrail (Morgan Stanley Investor Group)	344	396	574	
Forecast: Morgan Stanley May 1985 5-Year Plan:				
Consolidated Norfolk Southern/Conrail	1,070	882	1,118	
Conrail	642	439	660	
Consolidated Norfolk Southern/Conrail	1,070	856	1,081	
Conrail (paying dividends)	642	413	623	
Conrail (Morgan Stanley Investor Group)	642	427	634	
Forecast: Conrail June 1985 5-Year Plan:				
Consolidated Norfolk Southern/Conrail	1,007	1,050	1,094	1,160
Conrail (paying dividends)	579	607	636	648
Conrail (Morgan Stanley Investor Group)	579	612	636	644

Notes:

No taxes have been accrued for Conrail, and push-down accounting is assumed.

Norfolk Southern pre-acquisition net income is assumed to be $510, $525, $540 and $594 for 1986–1989. Estimates are for illustrative purposes only. In years 1986–1988 modest earnings growth rates are assumed. If similar assumptions are used regarding the growth in the economy/rail traffic as were used for Conrail in the June 1985 Conrail five-year forecasts or in the May 1985 Morgan Stanley Forecasts, these net income numbers would be higher. In 1989, a 10% growth rate is assumed. It should be noted that similar to Conrail's June 1985 forecast we have not factored into the projections an economic recession during the next five years. Given these factors, future financial results may be higher or lower than these projections.

Selected Pro Forma
Conrail Stand-Alone or as a Subsidiary of
Norfolk Southern Cash Flow Information[a]

Forecast	Proposal		1986	1987	1988	1989
Conrail June 1985	NS Paying No Dividends	Increase in Cash	$ 11	$ 34	$ 71	
		Payment of Dividends	-	-	-	
		Ending Cash	609	643	714	
		Minimum Cash Required	$500	$505	$500	
Conrail June 1985	NS Paying Dividends	Increase in Cash	$ 11	$ 23	$ 57	
		Payment of Dividends	109	18	62	
		Ending Cash	500	505	500	
		Minimum Cash Required	$500	$505	$500	
Morgan Stanley May 1985	Morgan Stanley Investment Group	Increase in Cash	$ 11	$ 22	$ 45	
		Payment of Dividends	121	121	121	
		Ending Cash	488	389	313	
		Minimum Cash Required	$500	$505	$500	
			failed test	failed test	failed test	
Morgan Stanley May 1985	NS Paying No Dividends	Increase in Cash	$211	$ 62	$ 277	
		Payment of Dividends	-	-	-	
		Ending Cash	809	871	1 148	
		Minimum Cash Required	$500	$500	$ 510	
Morgan Stanley May 1985	NS Paying Dividends	Increase in Cash	$211	$ 36	$240	
		Payment of Dividends	257	88	230	
		Ending Cash	552	500	510	
		Minimum Cash Required	$500	$500	$510	
Morgan Stanley May 1985	Morgan Stanley Investor Group	Increase in Cash	$211	$ 50	$251	
		Payment of Dividends	121	121	121	
		Ending Cash	688	617	747	
		Minimum Cash Required	$500	$500	$510	
Conrail June 1985	NS Paying Dividends	Increase in Cash	$ 47	$ 70	$ 76	$ 88
		Payment of Dividends	168	70	76	88
		Ending Cash	500	500	500	500
		Minimum Cash Required	$500	$500	$500	$500
Conrail June 1985	Morgan Stanley Investor Group	Increase in Cash	$ 47	$ 75	$ 76	$ 88
		Payment of Dividends	121	121	121	121
		Ending Cash	547	501	456	423
		Minimum Cash Required	$500	$500	$500 failed test	$500 failed test

[a] Common dividends are assumed paid in the May 1985 Morgan Stanley Proposal.

NS - Norfolk Southern

Postsale Pro Forma Financial Information
Summary Basis of Presentation and Assumptions

OVERVIEW AND PURPOSE

Objective - The purpose of the pro forma financial information is to illustrate comparatively the pro forma effect of the capital structures proposed under the Norfolk Southern Proposal and the Morgan Stanley Proposal on Conrail's future financial position and results of operations. Pro forma financial information has been prepared under three uniform sets of assumptions using various forecasts, as follows:

Pro formas based on Conrail Management's June 1984 Projections for 1986-88

- Case 1 • Norfolk Southern Proposal - no dividends
- Case 2 • Norfolk Southern Proposal - maximum dividends paid by Conrail to Norfolk Southern
- Case 3 • Morgan Stanley May 1985 Proposal

Pro formas based on Morgan Stanley revised projections:

- Case 4 • Norfolk Southern Proposal - no dividends
- Case 5 • Norfolk Southern Proposal - maximum dividends paid by Conrail to Norfolk Southern
- Case 6 • Morgan Stanley May 1985 Proposal

Pro formas based on Conrail Management's June 7, 1985 Projections

- Case 7 • Norfolk Southern Proposal - maximum dividends paid by Conrail to Norfolk Southern
- Case 8 • Morgan Stanley May 1985 Proposal

Since Conrail under the Norfolk Southern Proposal is under no obligation to pay out dividends, two cases are analyzed. One of these cases assumes no dividends from Conrail are paid to Norfolk Southern and the other case assumes the maximum amount as allowed by the covenants is paid to Norfolk Southern.

As a result of the factors enumerated below, the actual future financial position and results of operations may vary significantly from the pro forma presentations.

Subjective Factors - There are qualitative differences between the offers that can have a potentially significant effect on Conrail's future financial position and results of operations. Among others, these factors include synergy with the buyer's existing operations and management, yet to be agreed upon arrangements with labor and restrictive financial covenants. No adjustment has been included in the pro forma financial information to reflect these subjective factors.

Accounting and Valuation Factors - The proposed transaction is both complex and unusual. There is considerable diversity of opinion as to the appropriate accounting treatment and valuation for accounting purposes of certain aspects of the transaction. Consequently, the ultimate accounting and valuation may vary significantly from that presented herein.

Reliability Factors - The pro forma financial information for 1985 for cases 1-6 has been prepared based on Conrail Management's 1985 Budget as of December 14, 1984, and for cases 7-8 on Conrail Management's June 7, 1985 projections for 1985. For the years 1986-88, the pro forma financial information has been prepared based on Conrail Management's projections of June 6, 1984 (cases 1-3), on Morgan Stanley's revised projections for Conrail as contained in the Morgan Stanley Proposal dated May 14, 1985 (cases 4-6), and on Conrail Management's June 7, 1985 projections (cases 7-8). The Conrail Budget and projections and the Morgan Stanley projections have been relied on without review by Goldman, Sachs & Co. or its advisors and are subject to the risks of changing economic conditions, unforeseen events, and incorrect assumptions inherent in any projection.

POSTSALE PRO FORMA BALANCE SHEET

Accounting for the Purchase Transaction - The transaction has been accounted for as a recapitalization of Conrail with 100% revaluation of Conrail's assets and liabilities based on the assumed fair value of the new capital structure. The accounting principles governing certain aspects of this transaction are unclear. Consequently, the ultimate accounting for the transaction will be determined by the purchaser and its accountants subject to review by the Securities and Exchange Commission.

Employees' Equity - The employees' equity varies under the proposals. Pro forma financial information under each offer includes supplemental assumptions indicating the amount and accounting treatment of the respective employees' equity.

Government Equity - The purchase transaction is assumed to result in the elimination of all government equity. Consequently, the pro forma balance sheet reflects elimination of the existing debentures, Class A and Class B preferred stock and sale of the Government's common stock.

POST-SALE AND PRO FORMA INCOME STATEMENT

Basis of Presentation - The projections have been adjusted for only the factors enumerated below or specified under the offers. The transaction is assumed to take place January 1, 1986.

Wage Concession - For purposes of the pro forma financial information it is assumed that Conrail wage scales are restored to industry levels effective July 1, 1984. This assumption is already reflected in Conrail Management's 1985 Budget and June 7, 1985 projections and in Morgan Stanley's revised projections, but not completely in Conrail's June 1984 projections for years 1986-88. Accordingly, for cases 1-3 pro forma income for the years 1986-88 has been adjusted for the estimated additional wage costs.

Labor Protection Costs - Annual labor protection costs have been assumed to equal a $30MM suggested maximum for the Norfolk Southern Proposal. Other forecasts include labor protection costs approximating $10 million. This additional cost does not reflect any labor cost savings beyond those already included in Conrail Management's Budget and projections.

Depreciation - Book depreciation has been reduced by an estimated $150MM per year to reflect the decrease in recorded value of property, plant and equipment. While this assumption affects net income, it does not change cash flow.

Interest Income - Interest income has been adjusted for the differences in projected cash balances and pro forma cash balances.

Income Taxes - Because taxes accrued for financial reporting purposes do not affect cash flow and the difficulty of in projecting taxable income, no book provision has been made in the pro forma income statements for federal income taxes. This simplifies the analysis. In addition, it is assumed that a carryover tax basis for property and equipment will be available to the purchaser of Conrail stock. Deductions based on the carryover tax basis (based on Conrail's Management information), together with assumed deductibility of ESOP contributions or other payments to labor and investment tax credits are expected to reduce substantially or eliminate any tax provision during the projection period. While this assumption affects net income, it does not affect cash flow since any taxes would likely be deferred. State tax provisions have not been adjusted because they are not expected to differ materially from those already reflected in operating expenses in Conrail Management's projections. It is also assumed that any post-sale tax losses generated by Conrail would not be available to offset taxable income generated by non-Conrail operations. The amount of the deduction for ESOP contributions or other payments to labor under each of the offers is not presently determinable.

POSTSALE PRO FORMA STATEMENTS OF CASH FLOW

Basis of Presentation - The pro forma statements of cash flow have been prepared based on Conrail Management's and Morgan Stanley's projections adjusted for the pro forma effects under the offers pursuant to the above assumptions. In the cases based on the Morgan Stanley Proposal, common stock dividends are assumed to be paid regardless of the covenant limitations to demonstrate whether payments would be consistent with the covenants.

SUPPLEMENTAL ASSUMPTIONS SPECIFIC TO VARIOUS PROPOSALS ARE SET OUT BELOW

CONRAIL/NORFOLK SOUTHERN

Supplemental Assumptions

The basis of presentation and assumptions are as stated in the "Basis of Presentation and Assumptions" except as noted below.

- The $375MM ESOP contribution/payment to employees was assumed to be made at the closing using $300MM Conrail cash and $75MM of Norfolk Southern cash. (It is now understood that Norfolk Southern will not use any of Conrail's cash for this purpose. Any pro formas based on this new understanding would present Conrail's forecasted cash balances and net income more favorably than the ones presented in these exhibits.)

- No effect has been given in the pro forma financial information to the divestiture of rail operations by Norfolk Southern required by the Justice Department order nor to possible operating synergies between Conrail and Norfolk Southern.

- It is assumed that Conrail has no debt service obligation on the $1.2 billion Norfolk Southern borrowing during the projection period.

CONRAIL/MORGAN STANLEY INVESTOR GROUP

Supplemental Assumptions

The basis of presentation and assumptions are as stated in the "Basis of Presentation and Assumptions" except as noted below.

The general outline of the $1.2 billion proposal is contained in the "Morgan Stanley Proposal to Purchase the U.S. Government's 85% Interest in Conrail" dated May 14, 1985. Elements of the proposal include the following:

- Financing of the $1.2 billion through firm cash commitments from a diverse group of institutions and investors, including the CSX Corporation, whose stock interest will be placed in trust.

- Resale to the public, over the next five years, of a majority of the investor group's interest in Conrail such that it will own no more than 40% of Conrail after five years.

- For a five year period, no purchaser who originally acquires less than 10% of Conrail's common stock would be permitted to increase its ownership to above 10%, and no purchaser who originally acquires more than 10% could acquire any further shares.

- Payment at closing of $200 million to agreement employees and $30 million to non-agreement employees.

- Purchase of ESOP shares at $48 per share with total purchases of approximately $70 million.

- Annual dividend payments to stockholders of $121 million.

- Government will receive warrants to purchase one million shares of Conrail common stock at $48 per share at any time starting one year after the first public offering until June 1995. Warrants and warrant shares could be registered under the Securities Act beginning 90 days after first public offering of Conrail common stock.

In general, we used the assumptions and data from the Morgan Stanley proposal except that a closing date of 1/1/86 (instead of 7/1/85) was assumed, and for purposes of comparability with the Norfolk Southern pro formas, we have recapitalized Conrail with a 100% revaluation of the assets. This treatment does not affect Conrail's cash flow. We also have assumed that common stock dividends are paid each year regardless of any limitations from the covenants in order to demonstrate whether payments would be consistent with the covenants.

Exhibit 9

Conditions of Closing

The Morgan Stanley Proposal contains the following conditions and termination rights which are either not present or are more restricted in the Norfolk Southern Proposal:

- The Morgan Stanley Proposal is conditioned upon obtaining a special legislative exemption from Section 16(b) of the Securities Exchange Act of 1934, to permit the Purchasers to retain "short swing" insider profits. The statute, as currently in force, may require the Purchasers to forfeit to Conrail such profits from sales of Conrail common stock within the six months following the Closing.

- Under the Morgan Stanley Proposal, default by any one Purchaser (even one whose commitment is small) would excuse performance by all other Purchasers. The Morgan Stanley Proposal does not contain a requirement that the remaining Purchasers take up the commitment of the defaulting party. Although Morgan Stanley has informed us that its Proposal is now oversubscribed and that new Purchasers could quickly be located to replace any defaulting party, it should be noted that the assembly of the investor group has taken substantial time and that a repetition of this effort would be affected by future economic conditions and Conrail's performance.

- Morgan Stanley may terminate the transaction at any time before the Closing if there occurs any "calamity or crisis the effect of which...is such as to make it, in the judgment of [Morgan Stanley], impracticable to market the [Conrail] Stock for the foreseeable future". Such a provision is typical in underwritten public offerings, and Morgan Stanley representatives have informed us that this right is intended to deal only with major and unforeseen catastrophic events. We are concerned, however, that Morgan Stanley or one or more of the individual Purchasers might deem a material downturn in market conditions prior to the Closing to be such an event. The Norfolk Southern Proposal would excuse performance by Norfolk Southern if there were a material adverse change in Conrail's business, properties, results of operations or financial condition but the Norfolk Southern Proposal would not permit termination based upon fluctuations in the securities markets.

- It is a condition to the Purchasers' obligation that the registration statement covering resales by the Purchasers have been declared effective by the Securities and Exchange Commission. Since Morgan Stanley's proposed agreements do not appear to impose any obligation upon the Purchasers or Conrail to use their best efforts to effect registration, it is possible that the Purchasers or Conrail could withdraw the registration statement (or fail to take all steps necessary to permit effectiveness) before the Closing and then refuse to complete the purchase. Even if all parties did use their best efforts to obtain effectiveness, if registration were delayed by the Securities and Exchange Commission, the Purchasers would be under no obligation to proceed unless or until the registration became effective.

The CHAIRMAN. It was my understanding, listening to the last panel, who were investors, that they really are not anticipating making their money on dividends; instead they are anticipating making their money on turning over the stock. That is, they believe that at $1.2 billion, the stock is undervalued and that it will appreciate, and Mr. Saunders had some speculative numbers to which it would appreciate.

If that is their anticipation, that their money is going to be earned on the sale of the stock, does that mitigate the concern about dividends in perpetuity draining large amounts out of the company? I mean, maybe the dividend thing is just a short-term floor to provide the investors with their quick profit.

As Mr. Saunders himself said, if earnings and profits get below half a billion dollars, they would not pay the dividends. So maybe we should not be concerned about dividends as a drain.

Mr. BRODY. In the practical world of companies paying dividends, you find that once a company sets a dividend level, it is highly reluctant to lower that level of dividends. The reason that companies are highly reluctant to lower dividend levels is, it generally has an adverse reaction on stock price.

So therefore, once you start out at a certain dividend level, you will find that it becomes very difficult to move down from that level. If you follow that argument and believe it, what that says is the starting out dividend level is quite important, because it really sets the stage for what likely levels of dividends are.

And then the problem comes about: Typically, in the case of troubled companies, they get into trouble before they cut back on the cash going out of the company. I have not studied the Penn Central carefully, but I think that there is an analog there to the discussion that we are having right now.

Mr. MAI. May I just add one point to that? As you have suggested, there is a link between the high dividend at the beginning and the capacity of the investment group to get out at a profit. But I think, in the real world, if the situation at Conrail deteriorated to the extent that a dividend cut was necessary—and I agree with Mr. Brody, that is something that companies are very reluctant to do.

But if that came to pass, the people who would suffer as a result of the dividend cut would not be the Morgan Stanley group; it would be the public stockholders, because they would have flipped out of their stock and it would be a public company and the public stockholders would suffer that dividend cut.

The CHAIRMAN. Now, with respect to the payments of cash to the unions, Mr. Saunders says, well, that really does not make any difference because in the case of Morgan Stanley's operation, it is true that it is Conrail money, but in the case of Norfolk Southern, it is also Conrail money because it is all in one big pot.

Was that a reasonable analysis? Should we not be concerned by the fact that the union payment is made out of Conrail money in the case of Morgan Stanley and that it is made out of Norfolk Southern money in the case of the Norfolk Southern deal?

Mr. MAI. Well, the comment that Mr. Saunders made was indeed inaccurate. Norfolk Southern has committed that the funds that they would pay would come out of Norfolk Southern resources. It

would not come out of Conrail. I mean, that is a significant difference in the proposals, Norfolk Southern versus Morgan Stanley.

And it does matter, because you are talking about several hundred million dollars, and under the Morgan Stanley proposal you are talking about those several hundred million dollars coming directly out of the resources of Conrail, whereas you are talking in the case of Norfolk Southern about Norfolk Southern making that payment derived out of their own resources.

Mr. VOYTKO. The difference is the base. The money does come out of the same pool with Norfolk Southern, but as a portion of the resources, total resources of Norfolk/Conrail, it is a much smaller item. When you put it against Conrail standing alone, it begins to weigh very heavily in the cash flow statement.

The CHAIRMAN. Now, it is clear if the Morgan Stanley deal were to be agreed to there would be no deep pocket, is that not right? There would be no deep pocket?

Mr. VOYTKO. Unless you were prepared to provide one.

The CHAIRMAN. That is my ultimate question. My final question is going to be, what is the chance that the Federal Government is going to be back in this business? I do not want us to be back in this business, but let us put that question aside for a moment.

What is the significance of a deep pocket? Is Norfolk Southern a deep pocket? Does Norfolk Southern offer a backup strength to Conrail which is not offered by the Morgan Stanley deal, and what is the importance of that with respect to the long-term viability of Conrail?

Mr. MAI. Well, I think Norfolk Southern does offer a deep pocket. Firstly just in terms of pure cash resources, Norfolk Southern is one of the most liquid railroad companies in the United States. From a credit standpoint, it is one of the most highly rated railroad companies. And I think if you look at the history of the Norfolk Southern in terms of supporting its existing railroad operations, it has been an exemplary railroad operator in terms of capital expenditures and just keeping effective good railroad service behind its railroads.

So I think clearly that Norfolk Southern does have deep pockets and intends to operate Conrail, as I mentioned——

The CHAIRMAN. How important is it to the future of Conrail to have a sugar daddy behind the scenes?

Mr. MAI. Well, I think there is another element to the deep pocket issue, if I may, which is the commercial benefits which would flow from a combination of Norfolk Southern and Conrail. I think Norfolk Southern is interested in this because clearly they see that, in addition, they can make themselves stronger and they can make Conrail stronger.

And these benefits would ensue because, No. 1, you would have to give Conrail access into the Southeast through the Norfolk Southern network, and you would give Norfolk Southern better and more effective access into the Northeast through Conrail.

So I think that Norfolk Southern, as it measures the benefits of the merger, sees significant financial advantages to this association, and I think if you put everything together you are talking about a strong, effective railroad combination which would be not only a more effective competitor for CSX, but very importantly a

more effective competitor for the trucking industry, which is where the pressure has come on the railroad industry in the last few years.

Mr. VOYTKO. Could I take a shot at the deep pocket question? There are three aspects to the deep pocket.

One is just the total assets available. Norfolk Southern/Conrail would obviously have more.

The access to the capital markets. I think it is probably pretty clear that Norfolk Southern/Conrail's access would be bigger and a cheaper price. They would be able to raise more capital and at more favorable terms.

And the third thing that Norfolk Southern brings to the table is that they would aid Conrail's internal earnings and cash-flow power, something the Morgan Stanley plan cannot do and I do not think pretends that it can do.

That is really the three elements of the deep pocket, and you know it is not unfathomable. It ends at some point, like all deep pockets do.

How important is the deep pocket? It all depends on the situation Conrail finds itself in over the next 5 to 10 years. In a 2-year recession in which rail rates drop but rail labor rates go up, I think the deep pocket will be quite important.

Mr. BRODY. Let me just add one note of quantification to that last point. Whereas the Morgan Stanley proposal takes significant money out of the company for the payment of these dividends, the Norfolk Southern proposal adds money on an ongoing basis because of additional income generated. Conrail in 1983 in an information planning report estimated that from additional revenues alone the combination of Norfolk Southern and Conrail would add $80 million pretax income per year, in addition to whatever cost savings could be achieved in the area of rationalizing facilities, consolidating traffic flows, and integrating other functions. That is a big difference.

The CHAIRMAN. Senator Pressler.

Senator PRESSLER. Let me ask a couple of questions here. First of all, thank you very much for being here.

Now, you people are very familiar with the corporate world. Could you tell us as to whether there is a way to ensure that CSX does not influence the management of Conrail if that proposal went forward? Could you suggest a way to ensure this if you are not comfortable with the way Morgan Stanley dealt with that issue, or were you comfortable with the way Morgan Stanley dealt with that issue in testimony earlier today?

Mr. BRODY. Let me try to answer that. I think that if Morgan Stanley has not yet handled the CSX question satisfactorily, I would say that I would be very, very surprised if they could not come up with a solution which would satisfactorily handle the question of CSX involvement in management.

We do not look at that as an issue that cannot be solved and solved well by them.

Senator PRESSLER. Now, are you appearing here today—and I have great respect for all of you. I am just trying to get my figures straight. Are you appearing here today on retainer with the Department of Transportation, or what exactly is your role here?

You have appeared before us twice. You are a star. So I want to find out exactly. Are you on retainer for the Department of Transportation today?

Mr. BRODY. For the past 3-plus years, we have been acting as financial advisor to the Department of Transportation, and we continue to do so. We do not consider ourselves as pushing one proposal or the other. What we consider ourselves is doing professional analysis and providing professional advice as we see it.

Senator PRESSLER. But you were the ones from day 1. You are with DOT. I mean, if you did not agree with them you would not be here?

Mr. BRODY. We have made it very clear throughout this process, and we have made it clear here two times prior, that the ultimate selection of the purchaser involves both financial and public policy issues. We do not advise the DOT on public policy issues and therefore never come up with a recommendation that company A or plan B should be the way to go.

We just advise them on the financial aspects of the proposals.

Senator PRESSLER. I am just trying to get this straight. Now, Mr. Mai, you are with Shearson Lehman. Now, what is their interest in this? How did you come about being here today?

Mr. MAI. We are financial advisers to Norfolk Southern, and we have been for the past 15 months.

Senator PRESSLER. All right.

Now, Mr. Voytko, how did you come about arriving here today?

Mr. VOYTKO. I was asked.

Senator PRESSLER. By whom?

Mr. VOYTKO. By the committee, committee staff.

Senator PRESSLER. By the committee staff.

And does Paine Webber have any interest in this?

Mr. VOYTKO. No. As I said at the beginning of my testimony, we have no direct or indirect interest, though I wish we did.

Senator PRESSLER. And are you being paid by the committee, or you are just here as a good citizen?

Mr. VOYTKO. No, this is on Paine Webber's tab.

Senator PRESSLER. Pardon?

Mr. VOYTKO. This is on Paine Webber's tab.

Senator PRESSLER. Why is Paine Webber so generous as to send you?

Mr. VOYTKO. Why are they so generous? I guess a good deed to the public. You are asked to testify. I am supposedly an expert in the railroad business, particularly the stock market aspects of it. So I was asked, I came.

Senator PRESSLER. You are untainted.

Mr. VOYTKO. I cannot say I am untainted.

Senator PRESSLER. I am just having a bit of fun here. But I am just trying to establish where our investment banker panel came from and so forth. So we do appreciate your being here.

Now, I think that you all would agree, or that you said that the investors would make a bundle on this. And I apologize for going in and out of the room. I have been trying to deal with Nicaraguan demonstrators in my field offices and trying to tell the police please not to arrest them, because that is what they want, and so forth.

But getting back to Conrail, as I heard fleetingly, someone said that investors will make a bundle on this. Now, does that not imply that Conrail is worth more than the $1.2 billion offered, and why did Norfolk Southern not offer even more if they are able to realize these great economies of scale, et cetera?

And I will ask the two employees of the Department of Transportation and Norfolk Southern first.

Mr. MAI. Senator, I think that ever since the Department of Transportation designated Norfolk Southern as the preferred buyer of Conrail everyone in Congress has made it clear that if anybody wished to come up with a higher offer than the $1.2 billion that they were at liberty to do so, indeed that there would be a tremendous receptivity, I think, in Congress to such an offer.

And I think that, that the Norfolk Southern offer was put on the table several months ago, that nobody, including the Morgan Stanley group, has surfaced with an offer higher, I think is testimony to——

Senator PRESSLER. Why are they going to make a bundle, then? Why are the investors interested in it?

Mr. MAI. Because I believe that Morgan Stanley is counting on the fact that in a reasonably good stock market environment, which we are operating in right now, the fact that they are going to be paying a very high dividend, which is going to prop up the price, will enable them on a short-term basis to purchase the stock, and effectively warehouse it, and sell it to the public at a profit. So I think that they are counting on just short-term stock market considerations to justify a figure higher than $1.2 billion.

That is not the way, incidentally, that Norfolk Southern is looking at this. They are looking at this as a railroad integration acquisition on a long-term basis, and I think, having done an enormous amount of analytical work, Norfolk Southern feels that $1.2 billion is the right price and indeed the maximum price that they would be prepared to contemplate here.

Mr. BRODY. I believe that Secretary Dole stated when she was here, and we advised the Department of Transportation, that there is always a tradeoff between the financial return that the U.S. Government could achieve in the sale of Conrail and the resulting financial strength of Conrail. To the extent that the investor group of Morgan Stanley lessens their risk and enhances their short-term ability to capture gain by having a high level of dividends thereby decreasing the financial strength of Conrail, that really comes back to basically what Secretary Dole advised this committee when she was here before.

I do not think that we have the viewpoint, I do not think that we have stated, that they will make a bundle. I think our viewpoint is that they stand the potential to make some good money on it, and at the same time have a very low downside risk.

A further point is that, since the Norfolk Southern proposal was put on the table, since January, the stock market is better, interest rates are down, and the stock prices of other railroads are up 5 percent. So that there is the potential for having some greater gain than was contemplated then. The stock market surely will change between now and when this transaction is contemplated, whether or not we are pushing a stone or a rock uphill.

The last comment that I would make on this matter is, there is always the practical element of we are able to advise the Department that the offer that they have before them is within the range of fairness.

We have never advised them, and we never would advise you, that what they have received or what is being offered by either Morgan Stanley or Norfolk Southern is the best they can get out of either of those two, because as a practical matter when you are going to make a deal with somebody the only time that you know that you have gotten the absolute best out of someone is when you can say, if you do this you have the deal. No one so far has been in a position to say that to any of the proposals.

The CHAIRMAN. Senator Exon?

Senator EXON. Thank you, Mr. Chairman.

Gentlemen, thank you. It has been a very long, very interesting afternoon. You have had a lot of patience. You are at the end of the panel, and I thank you for being here. I thank you for your testimony.

Mr. Chairman, it seems to me that if we want to play it safe, then the safe thing to do is to accept the proposal from Norfolk Southern. I mean, I have learned that here today, I think. It may be safe, but I do not know how safe it is. I do not know how deep that pocket is.

I suppose that Norfolk Southern is a prime company and is one of the best run corporations in America, I am told by people in whom I have great confidence, such as the people of Union Pacific Railroad—in fact, they say it is almost run as well as the Union Pacific Railroad, and that is about as far as you would expect Union Pacific to go.

And I have the highest respect for Norfolk Southern, and I think maybe that would be the safe way to go although I suspect that if they are good managers, they have abandoned some tracks from time to time, they have abandoned some branch lines, they may have abandoned some main lines, and I suspect—and I am going to ask you in a question, Mr. Voytko, in just a minute, that is what I am leading up to—I suspect if we have a downturn in the economy for 1 year or 2 years, certainly I think that would adversely affect the Morgan Stanley proposal. I suspect also it would adversely affect the proposal by Norfolk Southern. They would have to make a determination of how far they wanted to go.

There is nothing in the proposal from Norfolk Southern that I know of that says that they will keep operating this line forever and guarantee that the Federal Government will never have to take it back over. So I guess it is a matter of degree.

I would say that while I am not sure there is as deep a pocket as some would want to believe, I suspect that the pocket is somewhat deeper, not quite as shallow, I might say, as Morgan Stanley might be. On the other hand, Morgan Stanley and their investors I do not think are going into this with the idea of losing money.

And I am not familiar with all of the stock manipulations that go on up in New York City from time to time. I am disturbed about the buyouts, the forced takeovers that we are wrestling with in other areas of our committee right now, but having said that, I think that there is something else, though, that we have to look at,

and that is the fact that we do not know what the Justice Department is going to say yet on the antitrust proposition.

And even if the Justice Department would say OK on antitrust, that does not mean that it is necessarily good for the public or competition to have a big and important railroad like Norfolk Southern taking over that much of the transportation of the United States.

So I look at all of this with rather mixed views, and I have not decided just which way I want to go on this yet

I do think, though, that the Morgan Stanley proposal is a tremendously interesting one that deserves some consideration from both this committee, the Department of Transportation and the U.S. Senate as a whole.

But my question, Mr. Voytko, is you made quite a point I thought—I listened very carefully to what you were talking about, you know, recession in 1 year and recession in 2 years.

What are you saying, that in your view and with your expertise in this whole area, as I understand it, the Morgan Stanley group would be more likely to bail out earlier if necessary than would be the case with Norfolk Southern?

Is that really what you are saying?

Mr. VOYTKO. Well, let's assume, Senator, that it is a severe 2-year recession. I hope that we never see one, but we may. The two questions would be how deep are the resources of each to last out such a recession. I think it is demonstrable that a Norfolk/Conrail combination would be stronger and could ride further although it would be hurt. All cyclical companies would be hurt.

The second thing is what are the options available to each essentially for bailing out. For Norfolk Southern they could abandon lines, but so could an independent Conrail to try to shrink themselves into profitability at a bad time, which is what Conrail has done successfully. And presumably, you know, they could try to sell, resell Conrail, but that would be very difficult. All we have found here in the past 4 years, selling a railroad is very difficult to do, whereas the Morgan Stanley investors could resell their stock at a loss, yes.

But there is such a thing in the investment business as cutting your losses. There is a way out for the Morgan Stanley investors that does not easily exist for Norfolk Southern. They would be stuck longer and would have to bear up.

Senator EXON. Since you are neutral in this matter, Mr. Voytko, have you viewed which would be best in the public interest, and whether we should have a Conrail standing alone? I tend to feel that if it were viable and if it had a reasonable chance of success, standing alone as a separate railroad probably would be in the interest of the consumer more than further expansion of a large company like Norfolk Southern.

Mr. VOYTKO. I would agree that more competitors for the shippers' business is better unless you feel that the competition is not likely to produce the returns necessary to any of the parties to continue to reinvest in plant, which has been the story of the railroads for the last 30 years. And so we have had a shrinking number of competitors out there. It has been a perfectly natural process.

The question is how do you do it? Do you do it painfully, through abandonments under economic stress, or through bankruptcies, as we have done in the last two decades, or do you try to help the process along by merging systems together. And the policy of the government has been—and I worked at the ICC during this period—has been to be a little more lenient on allowing railroads to merge, and hopefully to get the returns up so that they will reinvest in plant and not move money out of the industry and into other operations.

Senator EXON. One last quick question.

If, for example—let's go into ifs—next week the Justice Department would say that the offer by Norfolk Southern is in violation of the antitrust laws, and that they would not approve it, then what would you advise this committee and the Secretary of Transportation, to go ahead and take whatever risks you think are inherent in the Morgan Stanley proposal?

Mr. VOYTKO. Well, an awful lot of people do advise that right there. I guess the first person to look to would be Secretary Dole to find out what her reaction was. But if indeed the Justice Department felt that it was just not going to work, then the issue would be is Norfolk Southern willing to give more on divestitures to other railroads, things that would mitigate the antitrust impact? But I do not know that the Justice Department will say that. That is only speculative at the moment.

Senator EXON. Well, but even with that—I guess what I am interpreting from your answer then is that even with that eventuality, you would not automatically turn to Morgan Stanley, and you would more likely go back to Norfolk Southern and say what can we do to rectify the objections of the Justice Department?

Mr. VOYTKO. Exactly, Senator. If you think there are lots of merits in the Norfolk option versus Morgan Stanley, for whatever reasons, but you thought that there were antitrust problems with Norfolk and the Justice Department did, and apparently they did at the beginning, they asked for a certain set of activities that would mitigate those problems, and as I understand it, Norfolk has been engaged in carrying out those negotiations to divest the lines to create new competition.

A lot of antitrust problems can be fixed. It depends on the willingness of the merging parties to fix them and the government to accept the fixes.

Senator EXON. Thank you, gentlemen.

Thank you, Mr. Chairman.

The CHAIRMAN. Gentlemen, let me just put the same question to you that I put to Mr. Saunders.

We basically have three choices. We could in Congress enact legislation that would implement the Norfolk Southern sale, or we can enact legislation that would implement the Morgan Stanley proposal, or we could further study the matter, hold hearings, request more information, ask for reports of one kind or another, and keep the ball in play.

Do you have a view as to which of those three alternatives would be the worst alternative for the future of Conrail?

Mr. VOYTKO. Left to right or right to left?

The CHAIRMAN. Why do you not start, Mr. Voytko?

Mr. VOYTKO. I think doing nothing is a problem. I mean, we talk about Conrail as sort of an abstract entity, but really, it is people, it is salesmen, it is workers, it is management. There is turnover. You have to engage good people. In fact, since the Staggers bill, the railroad industry has become much more competitive.

The need for good people is always there. Investment decisions have to be made by Conrail in the plant, and they would differ whether it is going to be part of the Norfolk family or not. The more you delay, the more you hang up those investment plans and make them more difficult, the more difficult it is to attract good people and to keep good people. Already one senior executive from Conrail has left and joined CSX.

The CHAIRMAN. Mr. Mai?

Mr. MAI. I agree, that I think the worst outcome would be to do nothing. I think right now you have a lot of momentum, you have the right kind of environment both with regard to the economy and with regard to just people's outlook for the future as it relates to the stock market. So you have the momentum.

I think you have the momentum in Congress, and you do not know what circumstances you are going to be dealing with if you try to revisit the issue 1 or 2 years from now in the event that you did nothing. If we had a weak economy a year or two from now, or if we had a bad stock market a year or two from now, it is quite possible that Conrail simply would not be a saleable proposition for you.

And bear in mind that the time and the effort that not only Norfolk Southern has put into this whole process, but all the other buyers, but it is a drain on management for prospective buyers to go through this process. They are doing it because they believe that this is the right deal. But there is no assurance that a year or two from now that the kind of values you are talking about today would be realizable.

So I would certainly go for it, and needless to say, as a totally impartial observer, I think that Norfolk Southern would be the right course to go.

The CHAIRMAN. Mr. Brody?

Mr. BRODY. I agree with the observations that doing nothing does not serve the Government's interest. I disagree with the notion that therefore the only choice is to go Norfolk Southern or the Morgan Stanley proposal. If the Government were to decide not to go to Norfolk Southern, I think in relatively short order there could be other alternatives put on the table.

The CHAIRMAN. Oh, Mr. Brody, please.

Mr. BRODY. I am giving my viewpoint.

The CHAIRMAN. I am just telling you, I am not an expert on railroads, but I am becoming an expert in the Senate, and that is just an invitation to let's hear of these other alternatives, we really have to know about all of them and study them at great length and have hearings on them and get reports, analyses, let's get the Justice Department cranked into this. We are never going to come up for air.

How many proposals came in from DOT's original solicitation, 15, something like that?

Mr. BRODY. It was 15 or 16.

The CHAIRMAN. Fifteen or 16 different proposals came in and were reviewed, and I guess there are any number of possible combinations, and there is an infinite number of reports and analyses and number of hearings that we can hold. But I really think that we have two interesting proposals before us now. I think the worst thing we can do is just diddle around and let the year run out and not pass legislation.

My hope would be that we could frame this issue so that there would be a fair chance for a vote for the Morgan Stanley proposal, a fair chance to vote for the Norfolk Southern proposal, and get the thing passed, get the government out of the railroad's hair and the railroad out of the government's hair, hopefully forever.

That is one of the issues, whether it is forever or not. Hopefully forever, but I would really hope that we could get on with it.

Gentlemen, thank you very much.

Senator PRESSLER. Mr. Chairman, could I just make an observation here?

The CHAIRMAN. Of course.

Senator PRESSLER. I think another worst case scenario would be for us to, from my point of view, to create a monopoly that would severely hurt transportation in this country, and each of the answers was strictly on the financial aspects, and I would make just a note to disagree on that.

Also, I did not learn until a quarter to 7:00 that I had the option of calling the gentleman from Reebie Associates. My understanding is that he is no longer here, but earlier on I thought I got a negative when I asked, and it was not until—but I would like to ask unanimous consent to insert a statement, not a lengthy one, from him explaining the differences in the antitrust studies.

The CHAIRMAN. Fine.

VOICE. Senator, he has left, but if you had any questions, I could answer or else you could just send it in.

Senator PRESSLER. Shall we just call another witness?

I think it would be better to have a statement, let's say, of less than 2,000 words, a short one.

The CHAIRMAN. Anything you want, whether you want this gentleman to testify or want a statement, either way.

Senator PRESSLER. Let me also compliment our chairman. I think you have conducted a good hearing.

Let me add, and I appreciate your saying we could vote on one or the other, but also we must get an agreement from DOT that they will accept one or the other equally because if Senators have a choice, if you are voting for Morgan Stanley, but if you pass that, the whole deal is dead——

The CHAIRMAN. I do not think we can just continue to add various requirements on DOT or the administration. It seems to me that this is now in Congress' hands. We have reported a bill out of the committee and I really think that if you could get DOT to assure you one way or the other, fine, have at it. But my own view is that we have got two proposals before Congress, it is in our court now, and let's get on with it.

Senator PRESSLER. But would the argument not be used that the Department will not accept Morgan Stanley, it is futile to pass it?

The CHAIRMAN. I do not know whether the Department will accept it or not.

Senator PRESSLER. Let's ask them as a committee.

The CHAIRMAN. Why do you not ask them, and I will be glad to receive the information.

Senator PRESSLER. It would carry much more weight if the Chairman would also ask.

The CHAIRMAN. OK, that concludes the hearing.

[Whereupon, at 7:01 o'clock p.m., the committee recessed subject to the call of the Chair.]

ADDITIONAL ARTICLES, LETTERS, AND STATEMENTS

EASTERN COAL TRANSPORTATION CONFERENCE,
Washington, DC, June 11, 1985.

Hon. LARRY PRESSLER,
U.S. Senate, Room 407-A,
Russell Senate Building, Washington, DC.

DEAR SENATOR PRESSLER. Tomorrow, the Senate Commerce Committee will hold a hearing to examine the alternative plan for disposition of Conrail which has been put forward by an investment group led by Morgan Stanley and Company. The Eastern Coal Transportation Conference supports the Morgan Stanley proposal as a preferable alternative to the Department of Transportation's plan to sell Conrail to the Norfolk Southern Corporation, and commends the Commerce Committee for affording the Morgan Stanley group an opportunity to make its case. While the Committee has already voted on the DOT proposal, many other members of the Senate and House are still examining the relevant issues and formulating their positions, and will benefit greatly from a full and open hearing on the merits of the Morgan Stanley offer.

Even though the witness list for tomorrow's hearing does not include any shippers, we are confident of your awareness, and that of many other members of the Committee, of the impact on eastern and midwestern shippers which will flow from Congress' final decision on Conrail. It has been ECTC's consistent position that a sale of Conrail to any existing Class I carrier would be contrary to the public interest in enhanced, effective transportation competition. We continue to adhere to this position, and commend the Morgan Stanley proposal as a viable means by which to return Conrail to the private sector with minimal disruption of the existing structure of the eastern transportation market, and the lowest overall risk of adverse shipper impact.

Admittedly, the Morgan Stanley offer has been put forward rather "late in the game." In large part, however, this was due to the highly secretive manner in which the Conrail sale process was conducted by the Department of Transportation. Until the process was complete and the Secretary made public her proposal, neither Congress nor the public knew for certain what alternative had or had not been given meaningful consideration. For reasons that still have not been adequately explained, the Department apparently never seriously entertained the possibility of a genuine public sale of Conrail. This fact did not become clear, however, until earlier this year, when Norfolk Southern was presented to the public as the "successful bidder." In light of the late start necessitated by a lack of reliable information prior to that time, we find Morgan Stanley's ability to assemble committed investors and prepare a complete acquisition plan as quickly as it did quite surprising, and important evidence of the attractiveness of Conrail to the investing public.

We have examined the Morgan Stanley proposal carefully, and find that in all important financial respects it is equal or superior to the Norfolk Southern offer. Most important, however, the Morgan Stanley proposal carries no threat of anticompetitive consequences to shippers. In our view, this critical fact clearly tips the balance of merit in favor of the public offering alternative.

Thank you for the opportunity to share our views on this most consequential subject.

Very truly yours,

W.R. "DEWEY" MILLER, *Chairman.*

ECONOMIC DEVELOPMENT COUNCIL OF
NORTHEASTERN PENNSYLVANIA,
Pittston, PA, June 17, 1985.

Senator JACK DANFORTH,
Chairman, Senate Committee on Commerce, Science, and Transportation, Senate Office Building, Washington, DC.

DEAR SENATOR DANFORTH: Per the hearing held on June 12 concerning the Morgan Stanley proposal to purchase Conrail, enclosed you will find a copy of a resolution unanimously adopted by the Board of Directors of the Economic Development Council of Northeastern Pennsylvania. We would appreciate your entering this testimony in the record of the hearing.

Thank you for your consideration.

Yours truly,

HOWARD J. GROSSMAN,
Executive Director.

Enclosure.

RESOLUTION.—OF THE ECONOMIC DEVELOPMENT COUNCIL OF NORTHEASTERN PENNSYLVANIA (EDCNP) BOARD OF DIRECTORS IN SUPPORT OF AN INDEPENDENT CONRAIL AND OPPOSED TO THE SALE OF CONRAIL TO THE NORFOLK SOUTHERN CORPORATION AS PROPOSED BY THE UNITED STATES DEPARTMENT OF TRANSPORTATION

Whereas, the Economic Development Council of Northeastern Pennsylvania has provided strong support of the preservation of a rail system as an effective economic development tool for Northeastern Pennsylvania for many years; and

Whereas, the Council has had technical involvement in rail preservation in its region for over twelve years; and

Whereas, Conrail has been proposed for sale by the U.S. Department of Transportation under the Northeast Rail Services Act of 1981; and

Whereas, Secretary of Transportation Elizabeth Dole has recommended that Conrail be sold to the Norfolk Southern; and

Whereas, the EDCNP, on May 31, 1985, sponsored a major rail symposium on the sale of Conrail with speakers from the Federal Railroad Administration, Pennsylvania Department of Transporation, Pennsylvania Attorney General's Office, and others for the purpose of securing information and insight on the proposed sale of Conrail; and

Whereas, the persons eligible to vote at the symposium reached a consensus that the best position which the EDCNP could take with respect to the sale of Conrail would be to support an independent Conrail and therfore oppose the sale of Conrail to the Norfolk Southern.

Now, therefore, be it resolved, by the Board of Directors of EDCNP that:

1. When and if Conrail is sold, the company should only be sold and transferred into what is determined to be an independent Conrail, not tied to any particular rail company such as the Norfolk Southern; nor permitted to diversity into enterprises irrelevant to rail transport;

2. When and if Conrail is sold, as a condition of sale, the following factors should be taken into account:

a. The sale should retain a competitive railroad network in Northeastern Pennsylvania;

b. High and wide clearance routes to and through Northeastern Pennsylvania should be protected in order to protect the economic viability of companies requiring critical clearances;

c. The new company should continue to aggressively market for new economic growth, particulary as it applies to Northeastern Pennsylvania;

d. The public should have an opportunity to comment on the sale of Conrail through appropriate mechanisms including, but not limited to, a congressional public hearing to be held within Northeastern Pennsylvania on the sale of Conrail;

e. The proposed operating plan and financial pro forma statements, as well as other detailed information should be provided to organizations such as the EDCNP for comment and evaluation.

3. It is strongly urged that a public hearing be held in Northeastern Pennsylvania by the appropriate congressional committee(s) for the purpose of taking testimony on the impact of the sale of Conrail to Norfolk Southern and/or any othr party;

4. The sale of Conrail is so important to the economic future of Pennsylvania and Northeastern Pennsylvania that Congress should not permit the sale of Conrail to be incorporated within the budgetary reconciliation process, but should treat the

sale of Conrail as a separate and independent issue outside of the fiscal 1986 budgetary process;

5. The Executive Director of EDCNP is authorized to transmit copies of this resolution to appropriate officials.

SANBURN SUTHERLAND, PRESIDENT.

Adopted this 20th day of June, 1985.

STATEMENT OF THE NORTHEAST-MIDWEST SENATE COALITION MEMBERS*

We appear this afternoon as Co-Chairmen of the Northeast-Midwest Senate Coalition—a coalition encompassing most of the states in the primary service areas of Conrail. We thank you for the opportunity to testify.

More importantly, we greatly appreciate your decision to schedule this hearing. As you know this is a matter of fundamental concern to our Coalition, and we are here to urge that all care be taken to assure that the Nation and our States get the best possible deal.

We believe that our position is consistent with that of the Administration and this Committee—to return Conrail to the private sector in a way that has the greatest long-term public benefits. Our appeal is for thoroughness and caution since the stakes are so large, particularly for the States we represent. The review of benefits from the Morgan Stanley offering—of which we view today's hearing as the initial step—must be tested against the benefits of the other proposal.

Such benefits include the financial return to the government, the impact upon shippers and service patterns, and the impact upon employment in the region.

While we admire the tenacity and dedication of the Department of Transportation in moving this sale forward, we are deeply distressed about the process—the most serious flaw of which is the out-dated and inaccurate premise that an independent Conrail is not viable. With the Morgan Stanley proposal, the marketplace says this just isn't so. Over 30 blue chip, conservative investors are committing millions of dollars on a venture that cannot possibly pay off unless Conrail survives as a healthy railroad. That is a powerful marketplace endorsement of an independent Conrail, and carries with it a substantial degree of credibility. The recent REA study also predicted continued profits in future years.

Let's put this in perspective. When Congress intervened to bail out Lockheed, we did so in order to end up with a healthy competitive Lockheed. When we intervened to save Chrysler, we did so to end up with a healthy, competitive Chrysler. When we intervened to save the basic Penn Central system, we did so in order to end up with a healthy, competitive Conrail.

Surely, after pouring billions into this system to create a technologically advanced and productive railroad, after developing work rules and levels of employee efficiency that are the envy of the industry, after creating a railroad that a leader in the development of intermodal transportation, after affirming that the railroad is so strong that profits can be realized even when traffic declines unexpectedly, after all these things, surely we owe it to the Nation to be sure that both taxpayers and the States themselves can receive the best and most complete return on the $7 Billion public investment that has gone into Conrail.

Perhaps if there were no credible alternative we should sell Conrail to Norfolk Southern, but is it such a good deal? The Congressional Budget Office estimates that the government will net only $200 million, and that the deal will require unprecedented statutory antitrust immunity and force the government to make tax guarantees unavailable to any other business. At a minimum, the Morgan Stanley proposal gives hope of a better deal.

We commend Morgan Stanley and its investor group for stepping forward with this proposal. It shows initiative, a faith in marketplace solutions, and a willingness to accept risk that we think should be warmly embraced by Congress and this Administration.

With respect to the Morgan Stanley plan itself, on first inspection there appear to be a number of advantages that we trust the Committee will review and evaluate. Let us briefly outline them:

Compensation to the Government: The same amount of cash is offered under both the Morgan Stanley and Norfolk Southern proposal—1.2 billion—but in return Morgan Stanley is buying only the government's 85 percent share of Conrail while Norfolk is paying the same amount for 100 percent. Moreover, the Morgan Stanley

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* The following Senators are members: Alan J. Dixon, Co-Chair; Arlen Specter, Co-Chair; John Glenn; Frank R. Lautenberg; Carl Levin; and Paul Simon.

plan offers one million warrants as well. These are valuable, no risk assets that will allow the government to share in the growth of Conrail. Lastly, as CBO and the Joint Tax Committee point out, $400 million of depreciation is immediately available to shelter existing Norfolk Southern income. An independent Conrail would have no such existing income to shelter.

Continued Rail Competition: The end result of the Morgan Stanley offer would be the continuance of three competing railroads in the Eastern United States. It is axiomatic that the existence of three railroads will allow shippers greater bargaining power, result in greater price and service competition and maintain competitive pressure for increased productivity and innovations. We find ourselves in the unusual position of urging this Administration to consider an offer to purchase Conrail that will result in the greater affirmation of competition and free enterprise.

Treatment of Employees: While we will certainly defer to the employees themselves as to which plan is of greater benefit, we strongly believe the Committee should take into account the impact on rail workers. The Morgan Stanley plan appears to have substantial employee benefits. These include the continuance of employee ownership of a substantial block of Conrail, cash settlement of claims, and a guaranteed place on the Board of Directors.

Impact Upon the Region: In looking at the issue, we urge the Committee to consider the effects upon the region served by Conrail. At a minimum, Conrail is a major employer in our region. If rail labor's estimates of potential job losses from the Norfolk Southern offer are accurate, we will have a major problem on our hands. Conrail is an asset to our hard pressed economies. We have grave reservations about turning over its management to a group whose primary commitments are to a different region of the country.

With all this said, we have not yet had an opportunity to study adequately the Morgan Stanley plan. On its face it is very appealing and we look forward to the discussion that will follow today. We commend the Chairman for taking this first step, and we are most willing to work with him in the subsequent review of bids.

Again, we urge the Chairman and the Committee to take the time necessary to give each proposal careful study and scrutiny. The fact is, there is no compelling urgency involved in the sale. Conrail is doing perfectly well. Undue haste is simply unneeded, imprudent, and contrary to the public interest.

This process should be driven by sound transportation policy and not by a rush to get a one-time-only boost in the next budget cycle. If we can do so, great. But let's not jeopardize rail transportation in the East in the process.

We conclude with a message. Even though we are very disturbed about the process that has led us to this point today, we continue to share a common goal—the return of Conrail to the private sector.

We urge you to keep this as your highest priority. You have devoted tremendous time and energy to the process and you deserve praise for pressing Congress to resolve the issue. Indeed, if Congress decides that the Morgan Stanley plan, or any other for that matter, is preferable, this will be a clear victory for all. From the beginning of the bidding process, each plan has improved. If this final offer is the best for the public, we believe the credit will be due to this Administration for having begun the motion to get the job done.

Finally, let us repeat our highest praise for Chairman Danforth in scheduling this hearing. To us, it signals that this issue will be allowed to be debated on the Senate floor and that the full Senate will have an opportunity to vote its will.

Statement of the Procompetitive Rail Steering Committee

The Procompetitive Rail Steering Committee (Procompetitive Committee) welcomes and appreciates the opportunity to present its views to the Committee concerning the urgent need for preserving and promoting vigorous and enhanced competition between and among the nation's railroads, in the context of the proposed disposition of Conrail.

The Procompetitive Committee's basic position concerning the disposition of Conrail, as will be discussed more fully below, is that the Congress, the Administration, and other interested parties now have a golden opportunity to address and improve the intramodal rail competitive situation in the Northeast and the Midwest portions of this nation by ensuring that all necessary procompetitive conditions and arrangements will be implemented as an essential condition of Conrail's disposition, in whatever form it ultimately takes, in order to preserve and enhance competition in the Conrail service area and beyond. It is the further position of the Procompetitive Committee that the current proposals before the Congress, including the proposed

sale of Conrail to Norfolk Southern Corporation and the proposed public offering of Morgan Stanley and Company, should be assessed very carefully to ensure that they adequately address and provide for necessary and appropriate procompetitive conditions and arrangements.

IDENTITY AND INTEREST OF THE PROCOMPETITIVE COMMITTEE

The Procompetitive Committee is an organization comprised of member companies in the United States which are substantial users of railroad transportation. The Procompetitive Committee members are listed below:

Allied Corporation, American Iron and Steel Institute, Amoco Chemicals Company, Cargill, Incorporated, Celanese Chemical Company, Inc., CF Industries, Inc., Chrysler Corporation, Colt Industries, Inc., Ethyl Corporation, Ford Motor Company, FMC Corporation, ICI Americas, Inc., International Paper Company, and Libbey-Owens Ford Company.

Manville Service Corporation, Monsanto Company, Nalco Chemical Company, Occidential Chemical Corporation, Olin Corporation, Owens-Illinois, Inc., PPG Industries, Inc., Reichhold Chemicals Inc., Tennessee Eastman Company, Division of Eastman Kodak, Union Carbide Corporation, Uniroyal, Inc., and Wyandot Dolomite, Inc.

Members of the Procompetitive Committee represent industries which are tied to the railroads by production facilities designed for rail service, and distribution systems geared to long-distance, high-volume shipments, which generally are not adaptable to transportation by truck or intermodal service. Any attempt to change our members' dependence on rail service could not be accomplished without massive capital infusions and unacceptably high increases in operating costs. In addition, the products shipped by some members of the Procompetitive Committee are fungible, bulk and low-value goods with rail transportation costs representing a significant percentage of their delivered value. Here again, such shipments are captive to the railroads and vulnerable to monopoly rail pricing abuse. Consequently, members of the Procompetitive Committee are vitally interested in the maintenance of a financially healthy, competitive, market-disciplined and efficient rail system adequate to move the nation's commerce and support the nation's defense needs.

The Procompetitive Committee remains firmly dedicated to competition and marketplace forces as the best regulator of railroad service. It is the conviction of the Procompetitive Committee that a fundamental purpose of the Staggers Rail Act of 1980 is to encourage, promote and strengthen intramodal rail competition. However, the Procompetitive Committee has deep concern that this objective of vigorous and enhanced competition within the rail industry has been down-graded or ignored by the Interstate Commerce Commission and the railroads. Indeed, the Procompetitive Committee is extremely concerned with the substantial reduction in intramodal railroad competition, and the resultant injurious impact this reduction has had and will continue to have on the nation's shippers and consumers. We here refer to the actions of certain railroads, whereby they have embarked on programs of cancelling joint rates and through routes, closing rail transportation gateways, undermining, terminating or dramatically increasing the charges for reciprocal switching arrangements, thereby sharply reducing the availability to the shipping public of genuine intramodal rail competition.

Moreover, it is important to emphasize that this is all occurring in a background of mergers and consolidations which are producing powerful railroad systems such as The Union Pacific-Missouri Pacific, the CSX Lines, the Burlington Northern-Frisco and the Norfolk Southern. In addition, there is currently pending before the Interstate Commerce Commission the merger application involving the Santa Fe and Southern Pacific. Moreover, the financial press is currently presenting reports of a possible acquisition by the Union Pacific System of the Missouri-Kansas-Texas Railroad. Of course, particularly pertinent here is the matter of the proposed disposition of Conrail, the subject of recent hearings before this Committee. Our comments are specifically directed to the latter.

APPROACH TAKEN BY THE PROCOMPETITIVE COMMITTEE IN THIS STATEMENT

Enhanced intramodal railroad competition, as emphasized above, is the essential requirement for the balanced and effective implementation of the Staggers Rail Act of 1980, for the attainment of the Congressional goal of vigorous competition embodied therein, and for the protection of captive shippers and receivers from abusive railroad monopolistic or otherwise anticompetitive pricing and practices. One of the fundamental objectives of the Procompetitive Committee is to take steps to achieve vigorous and enhanced intramodal railroad competition so that the overall objectives of the Staggers Rail Act can be realized to the fullest. To this end, the Procom-

petitive Committee has presented and will continue to present its views to the Congress, to the Interstate Commerce Commission, and to the public.

In addition, the Procompetitive Committee has developed limited but specific clarifying legislation to ensure the achievement of the intramodal railroad competition which was to be available under the Staggers Rail Act. A copy of this legislative proposal, as thus far developed, is attached for the information of the Committee, as Appendix A. A separate section-by-section summary of this legislative proposal is also attached for convenience as Appendix B.[1] As will be noted by reference to these two appendices, the Procompetitive Committee's legislative program embraces, among other things, the subject of through routes/joint rate cancellations, establishment of competitive joint and proportional rates, reciprocal switching, use of terminal facilities, and railroad mergers. The Procompetitive Committee would emphasize in this respect that it is not seeking re-regulation of the railroad industry. It merely seeks to fulfill the basic objective of the Congress when it enacted the Staggers Rail Act. Vigorous intramodal rail competition is not only desirable, it is essential as an alternative to regulation, when shippers do not have the protection of competitive forces and are confronted with the actual or potential abuse of railroad market power.

From this overall perspective, the Procompetitive Committee views the various proposals for the disposition of Conrail as an opportune time for taking necessary and appropriate steps on the part of the Congress, the Administration, and interested parties substantially to improve the intramodal rail competitive situation in the Northeast and the Midwest portions of this nation, as part of the overall and ongoing effort to preserve and enhance vigorous and effective competition within the railroad industry generally.

The Procompetitive Committee therefore urges this Committee, as it does the Congress generally, in reviewing this crucial subject of the proposed disposition of Conrail as an individual matter, and as a piece of the overall mosaic of the railroad industry, to ensure that the public interest generally is being advanced in terms of enhancing and ensuring vigorous competition between and among the railroads, the effects of which will ultimately redound to the benefit of shippers and receivers, consumers, and indeed the railroads themselves.

Thus, as to the disposition of Conrail, the Congress should satisfy itself that existing competition between and among Conrail, Norfolk Southern, CSX Railroads, and smaller, regional carriers will not be significantly reduced or eliminated by any disposition of Conrail. The Congress should likewise ensure that those areas of the Northeast which are now subject to a service monopoly by Conrail become open to effective competitive rail alternatives through the provision of joint rates, proportional rates, trackage rights, reciprocal switching arrangements, and other procompetitive arrangements, as may be appropriate and necessary. Further, any divestiture program must assure strong head-to-head competition at all major points in the involved territory.

At the very least, the Congress should take steps to ensure that the matter will be subjected to thorough and rigorous study, analysis and action so that all essential, procompetitive conditions and arrangements can and will be implemented to preserve and enhance competition in the Conrail service area and beyond. Certainly, the Congress should take the necessary time to ensure that procompetitive concerns are adequately addressed in this important matter. The essential point is that the Congress should be prepared to take a comprehensive, horizon-type view of these crucial issues involving competitive access to ensure that shippers and receivers are adequately protected from abusive railroad practices and to ensure that the general public interest is advanced.

With respect to the proposed sale of Conrail to Norfolk Southern, the Congress should ensure that the divestitures suggested by the U.S. Department of Justice and the joint-route protections and reopenings recently agreed to by Norfolk Southern and certain regional carriers adequately address legitimate concerns about the reduction of intramodal rail competition in the Conrail service area, and that strong, viable and enhanced intramodal rail competition in the area involved is actively promoted in any disposition involving Norfolk Southern. Similarly, in the Procompetitive Committee's view it is imperative that any public offering such as the one proposed by Morgan Stanley adequately addresses procompetitive concerns and actually promotes vigorous and enhanced intramodal rail competition in the Conrail service area.

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[1] Appendix A and B were not reproducible and are in the Committee files.

The Procompetitive Rail Steering Committee appreciates the opportunity to present its general position concerning Conrail's disposition in the context of the role it has played and should play in the overall railroad industry in this country. While at this time, as indicated above, the Procompetitive Committee does not endorse any particular disposition of Conrail, it does applaud the return of the government's interest in Conrail to the private sector. The means of accomplishing this return, however, must be carefully selected not only to preserve but to enhance intramodal railroad competition in the Midwestern and the Northeastern portions of the nation. Failure to utilize this opportunity to improve rail-to-rail competition in these areas will be a tragedy and one which could ultimately lead to reregulation of rail transportation by the government in those areas as well as a denial to shippers, receivers, and consumers of the procompetitive benefits envisioned by the Congress in the Staggers Rail Act.

The Procompetitive Rail Steering Committee urges that all necessary and appropriate procompetitive conditions be considered and made a part of any Conrail disposition so that it will be a positive, rather than a negative, event, and one which will be in the long-term interest of shippers, receivers, consumers and the railroads themselves. Indeed, the Procompetitive Committee recommends that a similar basic approach be also taken with respect to all future proposed railroad mergers and consolidations.

The Procompetitive Rail Steering Committee thanks the Committee for its consideration of the views expressed in this statement.

Statement of Andrew C. Robertson

My name is Andrew C. Robertson. I am employed by Reebie Associates located at 200 Railroad Avenue, Greenwich, CT 06830. I have participated in several rail merger analysis projects over the past five years including UP-MP-WP, GTW-MILW, ATSF-SP, and most recently USDOT's sale of Conrail. I have submitted testimony before the Interstate Commerce Commission on behalf of Grand Trunk Western concerning their anticipated losses to NS-CR and the viability of NS' proposed divestitures to P&LE and GTI. I am thoroughly familiar with the marketing and antitrust issues that surround the NS-CR case.

INTRODUCTION

In March, 1984, the Department of Justice (DOJ) submitted testimony before the Interstate Commerce Commission addressing the anti-competitive impacts of the proposed Santa Fe-Southern Pacific (SF-SP) railroad merger. The testimony of DOJ economist, Dr. Russell Pittman, was based on an analysis of the combined market shares of SF and SP. Reebie Associates provided market share information to Dr. Pittman. As Dr. Pittman's primary contact with our firm, I am very familiar with his methodology and analysis.

In May, Reebie Associates was asked by RBC Associates to use the Pittman-DOJ methodology to produce a comparable market share analysis of the proposed Norfolk Southern-Conrail (NS-CR) consolidation. In my testimony, I will briefly outline the Pittman-DOJ analytical approach. I will then use the market data produced by his analytical approach to support five conclusions:

1. By Dr. Pittman's standard of merger affected tons, the scope of the anti-competitive impact of NS-Conrail is much larger than that of SF-SP.
2. NS-Conrail will control many more market areas than ATSF-SP, primarily in the Northeast and Midwest.
3. Many commodities most severely impacted by NS-Conrail such as coal, iron ore, pulp and corn are not protected from rail monopolies by motor carrier competition.
4. Many NS-Conrail markets identified as problems by the Pittman-DOJ methodology are not addressed by the Pittsburgh & Lake Erie-Guilford divestiture plan.
5. The Pittman-DOJ methodology appears to differ significantly in form and substance from that used in the DOJ's evaluation of NS-Conrail.

PITTMAN-DOJ METHODOLOGY

Market definition

Dr. Pittman used Business Economic Areas (BEAs) to define geographic areas in his analysis. These areas were established by the Department of Commerce to correspond to the economic areas surrounding major centers of industrial and commercial activity. BEAs have been used extensively in every recent rail merger case.

In the Pittman-DOJ methodology commodities are defined by Standard Transportation Classification Code (STCCs) at the five digit level of detail. This level of detail is precise enough to separately identify industries that share similar transportation requirements.

Market share test

Dr. Pittman's analysis is designed to identify every case where intramodal competition in the rail market would be significantly affected by a merger. Dr. Pittman employed a market share screen known as the "10-10-50 Test" in his examination of the SF-SP rail merger. By this test, in the analysis of the NS-CR consolidation:

NS market share is greater than 10 percent and Conrail market share is greater than 10 percent and NS-CR combined market share is greater than 50 percent.

Dr. Pittman's methodology would identify as a "problem" market a case where for a particular commodity flowing between two BEAs, NS' share of rail traffic is 25 percent and Conrail's share is 40 percent with a combined share of 65 percent. As both NS and CR have at least 10 shares and together over 50 percent of the rail market, this hypothetical case would meet Dr. Pittman's standard. This rule is applied to markets defined by origin-destination traffic lanes, total inbound flows to destinations, and total outbound flows from origins.

The Pittman-DOJ methodology separately identifies these markets where either NS or CR have total control from those where NS and CR are competitive. Although, a market where a NS share of 92 percent is combined with a CR share of 8 percent would not meet the 10-10-50 test, Dr. Pittman considers these exclusively served markets to be "potential" problems.

Market shares are assigned to NS or CR if they participate in a rail movement as an origin, destination or overhead carrier. Therefore, NS would have a share of the traffic moving from N&W in Virginia to B&M in Massachusetts or by a joint FEC-SOU-GTW route.

Market share reports

In Dr. Pittman's testimony, he produced eight tables to provide different perspectives of the competitive impacts of SF-SP. I have used Dr. Pittman's exact report formats with the 1983 ICC Rail Waybill Sample and 1982 TRANSEARCH truck and barge data to reproduce the Pittman-DOJ analysis for the NS-CR case.

Six reports use the "10-10-50 Test" to identify problem markets for three geographic orientations.

By Origin-Destination Traffic Lane e.g. traffic from Cleveland to Chicago—Tables I-II.

By Destination e.g. traffic into Cleveland—Tables IV-V.

By Origin e.g traffic out of Cleveland—Tables VI-VII.

For each of these geographic orientations, there is a separate "sort" of the data to focus on the commodities and locations most impacted by the NS-CR combination.

Dr. Pittman also designed two reports (Tables VIII-IX) to identify markets where combining railroads either alone or in combination have 100% market share.[1] These reports rank the locations and commodities dominated by NS or Conrail.

MARKET ANALYSIS

I have examined the market share reports and testimony developed by Dr. Pittman for SF-SP and the comparable market share reports created for NS-CR. My comparison of the data supports the conclusion that the NS-CR combination, by several measures of market power, is more significant than the SF-SP merger. Furthermore, the proposed divestitures to P&LE and GTI fail to address several markets that rely on NS and Conrail competition.

I have appended to this testimony, the first two pages of each of my eight market share reports (Attachment 1).[2] I will use these reports to illustrate my analysis of the impacts of NS-CR.

Origin-destination pairs with high NS-CR shares

Tables I and II identify the origin-destination markets where NS and Conrail rail shares meet the "10-10-50 Test". Table I identifies the locations most affected by the combination. Review of the report's first two pages shows that of the twenty-six origin-destination pairs most affected by NS-CR, 12 are not addressed by the pro-

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[1] Dr. Pittman's methodology makes no provision to identify markets that do not meet the "10-10-50 Test" or this 100% market control test. For example, a market where Conrail has a 90% share and NS has a 5% share would not be picked up by the Pittman-DOJ methodology.

[2] Attachments 1 and 2 were not reproducable and are in the committee files.

posed P&LE-GTI divestitures. I have examined every traffic lane in Table I and have identified the origin-destination markets that cannot be served by the P&LE/GTI new lines. Of the 22.1 million affected tons in this report, only 44% can possibly be routed by the expended P&LE/GTI systems.

In some cases, the new lines of GTI and P&LE do not serve affected market pairs eg. Chicago to Lansing. In others, they cannot offer service that is independent of NS or CSX eg. Ft. Wayne to Baltimore. In my analysis, I have assumed that GTI/P&LE will have access to the broad range of NS-CR shippers in their new divested markets. This is a very liberal assumption when considering the very limited scope of NS' line divestitures in key markets such as Chicago, St. Louis, and Indianapolis. The second largest impacted traffic flow—coal from Wheeling to Cleveland—will probably be unaffected by the divestitures because NS ensured that P&LE did not gain access to coal mines near Wheeling and utilities in Cleveland.

Table II identifies the commodities with the most affected tonnage when the "10-10-50 Test" is applied to origin-destination pairs. The principal affected commodities, viz. coal, grain, scrap, plastic pellets, paper and motor vehicle parts are all similar in their reliance on rail transportation. Review of the "Truck/Barge" shares show that rail has little significant intermodal competition for most of the affected commodities.[3]

Destinations with high CR/NS rail shares

Tables IV and V show the results of the application of the 10-10-50 Test to total commodity movements *into* a market area. Table IV identifies Cleveland, Evansville, Washington, Boston and Wheeling as the areas where NS and Conrail compete most vigorously for terminating traffic. In Cleveland, there are 37 affected commodities with over 10,000 tons. Intermodal competition is important (i.e. truck-barge share over 50%) for only eight of those commodities.

The GTI and P&LE divestitures do not serve the Washington and Evansville markets. It is more difficult to estimate the potential strength of GTI and P&LE in markets they do serve. Review of the "Other Rail Share" traffic terminating in Boston indicates that Guilford has limited shares for most affected commodities. GTI's weak market position in its present markets such as Boston, Philadelphia and New York and P&LE's weakness in Pittsburgh make it difficult for them to serve as an effective replacement to Conrail.

Table V identifies the commodities most affected by NS-CR control of destination traffic in key market areas. Many of the same commodities identified in the origin-destination analysis appear in this table. Table V shows that NS and CR in combination will have dominant market positions for several large commodity movements.

COMBINED NS-CR SHARE

[Percent]

Coal into Cleveland	64
Paper into Cleveland	85
Corn into Baltimore	70
Steel into Lansing	91
Plastics into Boston	63

These very high shares show the large scale of the proposed NS-CR system. They also indicate that GTI and P&LE must be able to attract a substantial amount of traffic if they are to serve as a meaningful competitive check to NS-CR.[4]

Origins with High CR-NS Rail Shares

Tables VI and VII show the origin markets that meet Dr. Pittman's "10-10-50 Test". The results differ from the destination markets because of the different mix of rail freight consuming and producing industries in each market and CR's and NS's access to these industries.

Tables VI shows that Cleveland origin traffic will be most affected in terms of tonnage. Detroit is not served by GTI or PLE and will be highly dependent on NS-CR for traffic to the East and South. The P&LE was given very little additional

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[3] The source of barge and truck market information, TRANSEARCH, does not fully describe intermodal competition at the 5-digit STCC level of commodity definition chosen by Dr. Pittman.

[4] The impact on Eastern coal-fired utilities will be particularly severe. The reliance of 50 power plants on NS and CR competition is confirmed in a recent study for the Interstate Commerce Commission Coal Fired Utilities Dependency on Rail Carriers as a Transport Delivery Mode.

trackage in Pittsburgh to complement its relatively weak market position. Both PLE and GTI serve Toledo but only via highly circuitous routes. P&LE was given enhanced access in the Wheeling and Youngstown areas. However, NS chose to retain access to every major traffic generating point on the divested lines. In sum, the new divested lines will have a limited benefit in several of the most impacted origin market ares.

Table VII shows that the NS-CR combination will eliminate intramodal competition at the origin for several rail dependent commodities. NS-CR will have over 50% shares of at least thirteen origin commodity movements of over 1,000,000 tons.

Corn from Toledo, Columbus and Lafayette, IN.
Sheet Steel from Pittsburgh, Youngstown and Cleveland.
Motor Vehicle Parts from Detroit.
Cyclic Intermediates from Houston.
Steel Pipe from Cleveland.
Soybean Cake from Champaign, IL.
Steel Bars from Cleveland.
Broken Stone from Toledo.

As most of these commodities are heavily dependent on rail transportation, Conrail and NS are now the only competitive alternatives available to many "affected" shippers. To be truly competitive, P&LE and GTI's new systems will have to serve a much broader market than their traditional bases in the steel and paper industries respectively.

Origin-destination pairs served exclusively by NS-CR

The Pittman-DOJ methodology focuses in those markets where there is clear evidence of serious intramodal competition. The Department of Justice has traditionally been less concerned about instances of present monopoly control deeming them to be unaffected by a new combination of competitors. Dr. Pittman separately identified these cases in his Tables VIII and IX.

Table VIII shows the origin-destination markets currently controlled by NS and/or Conrail. Review of the first two pages of the table show that Conrail has complete control of many important rail markets. If NS acquires Conrail it would, in turn, become the monopoly carrier in many parts of the Northeast. The data also show that a combination of NS and Conrail market shares in several markets such as Cleveland to Wheeling and Toledo to Cleveland will result in the elimination of "potential" NS and CR competition. It should be noted again that the Pittman DOJ methodology only selects markets where NS-CR share is 100%. If their combined share reaches only 94% or 97%, they would be screened from Tables VIII and IX.

Table IX identifies the commodity movements now controlled by NS or Conrail. The combination of NS and Conrail monopoly markets will have the most immediate impact on the coal, stone, steel and grain industries. The combined NS-CR route structure will also include many of the important service routes for piggyback shipments as well.

COMPARISON OF NS-CR AND SF-SP MARKET IMPACTS

The comparison of the NS-CR and SF-SP rail combinations cannot be based solely on review of quantitative market share data such as that asembled by Dr. Pittman. Indeed, the Pittman methodology is not definitive as there are several other useful measures of the antitrust implications of a rail merger. There are many subjective issues differentitating NS-CR from SF-SP that cannot be portrayed in market share reports. However, the Pittman market share analysis is as comprehensive as any other presented in previous rail merger cases. A straight comparison of the NS-CR and SF-SP share data produced by the Pittman-DOJ methodology is an objective way to identify many of the differences and similarities between the two cases.

To illustrate my analysis I have made copies of the first page of the Pittman's Tables I-IX (Attachment 2) to compare with the NS-CR tables (Attachment1). I will organize my discussion in two parts to cover the location and commodity impacts of the two transactions.

Location impacts

Pittman's Tables I, IV, VI and VIII identify the market areas affected by the ATSF-SP merger. They differ to the extent that SF and SP compete differently in origin-destination lanes, origins, or destinations.

Traffic Lanes (Table I) The origin-destination pairs most impacted by SF-SP cover the Western part of the country from Chicago to Houston to Los Angeles. By contrast, the lanes where NS and CR are most competitive are concentrated in the

Northeast and Midwest in the region bounded by St. Louis, Baltimore and Detroit. This would suggest that divestiture could be a means to ameliorate the anticompetitive effects of NS-CR.

EXHIBIT 1

ORIGIN AND DESTINATION MARKETS MOST AFFECTED BY SF-SP MERGER

Origin	Tonnage affected	Destination	Tonnage affected
1. Houston	10,800,440	1. Los Angeles	25,254,976
2. San Francisco	8,427,520	2. Chicago	10,127,110
3. Los Angeles	7,280,135	3. Houston	8,912,315
4. Kansas City	4,672,340	4. Phoenix	3,298,410
5. Fresno	4,054,860	5. San Francisco	2,390,440
6. Chicago	3,430,860	6. Dallas	1,983,078
7. Seattle	2,726,530	7. San Diego	917,550
8. Fort Dodge	2,559,230	8. Tyler, TX	816,670
9. Beaumont	1,641,850	9. Beaumont	793,340
10. Portland	1,011,870	10. New York	662,350
11. Detroit	877,160	11. Oklahoma City	593,894
12. Phoenix	842,070	12. Boston	512,740
13. Baton Rouge	717,800	13. Fresno	492,240
14. Amarillo	704,469	14. Kansas City	491,370
15. Dallas	583,755	15. Philadelphia	334,020
16. Stockton	567,995	16. Stockton	259,750
17. Reno	549,694	17. El Paso	214,220
18. Wichita	523,525	18. Amarillo	199,030
19. San Antonio	470,710	19. Waco	149,960
20. Minneapolis	469,270	20. Memphis	120,790
21. Denver	369,250	21. Portland	73,795
22. Davenport	338,900	22. Grand Rapids	73,270
23. Lake Charles	331,970	23. Greenville	73,030
24. Missoula	323,450	24. Minneapolis	69,140
25. Appleton	309,000	25. St. Louis	65,400
Total	54,584,653	Total	58,878,888

EXHIBIT 2

ORIGIN AND DESTINATION MARKETS MOST AFFECTED BY NS-CR MERGER

Origin	Tonnage affected	Destination	Tonnage affected
1. Cleveland	9,043,977	1. Cleveland	32,545,920
2. Detroit	8,689,947	2. Evansville	9,885,115
3. Pittsburgh	5,439,257	3. Washington	7,996,423
4. Toledo	5,141,018	4. Boston	4,353,400
5. Youngstown	2,964,961	5. Wheeling	3,483,650
6. Wheeling	2,955,790	6. Baltimore	3,368,495
7. Chicago	2,755,866	7. Indianapolis	2,799,365
8. Houston	2,727,120	8. St. Louis	2,159,843
9. Columbus	2,572,180	9. Lansing	2,133,579
10. Champaign	2,368,844	10. Columbus	1,888,059
11. Lafayette	1,985,998	11. Chicago	1,498,514
12. Springfield	1,749,198	12. Buffalo	1,345,939
13. Buffalo	1,506,113	13. Toledo	1,296,822
14. Ft. Wayne	1,341,007	14. Pittsburgh	1,083,766
15. Rocky Mount	1,178,443	15. Cincinnati	1,018,272
16. Anderson	975,415	16. Detroit	973,138
17. Kokomo	964,866	17. Champaign	748,176
18. Duluth	926,877	18. Hartford	592,689
19. Lima	887,479	19. Ft. Wayne	554,913
20. Roanoke	853,110	20. Kansas City	531,947

ORIGIN AND DESTINATION MARKETS MOST AFFECTED BY NS–CR MERGER—Continued

Origin	Tonnage affected	Destination	Tonnage affected
21. Charleston, WV	823,367	21. Harrisburg	485,690
22. St. Louis	816,331	22. Kokomo	381,683
23. Richmond	783,157	23. Atlanta	291,134
24. Savannah	773,110	24. Philadelphia	175,163
25. Memphis	746,318	25. Albany	262,783
Total	60,969,749	Total	81,854,478

Destinations (Table IV) Exhibit 1 identifies the 25 destination areas with the largest amounts of tonnage affected by SF-SP. This parallels Pittman's Table 1A in his testimony. Exhibit 2 produces comparable data for the 25 destination markets most impacted by NS-CR. Six market areas have over 1,000,000 affected tons in the Pittman analysis of SF-SP. The same methodology identifies fifteen NS-CR market areas with over 1,000,000 affected tons. The 25 largest NS-CR market areas have in toal 81.9 million affected tons or 139% of the top 25 SF-SP destination markets.

Origins (Table VI) The comparison of Exhibits 1 and 2 for origin traffic again shows that NS-CR will have a larger impact than SF-SP in terms of affected tons. Fifteen NS-CR origin markets are greater than 1,000,000 tons; only ten SF-SP markets are at that level. NS-CR affected tonnage in the top 25 origin areas is 111.7% of the total for SF-SP's top 25 origin markets.

The map in Exhibit 3 [5] portrays the origin and destination markets with over 1,000,000 tons affected by NS-CR or SF-SP. Clearly NS-CR's impacts are more concentrated geographically than those of SF-SP. However, many more markets are affected by NS-CR.

Exclusively Served Markets Table VIII in Pittman's testimony identifies the origin-destination traffic lanes that would be controlled by SF-SP. They are concentrated in the region stretching from San Francisco to El Paso. The pattern of NS-CR controlled traffic lanes is less clear. However, there is a high concentration in the Northeast where Conrail is today the dominant carrier.

One simple comparison of the potential monopoly power of NS-CR versus SF-SP can be made. Dr. Pittman's SF-SP Table VIII has 57 pages; my NS-CR Table VIII has 335 pages.

Commodity impacts

Dr. Pittman's Tables II, V, VII, and IX examine the commodities most affected by a rail merger.

Traffic Lanes (Table II) Dr. Pittman identified two commodities with over 1,000,000 affected tons in traffic lanes where SF and SP compete: corn and plastic pellets. Coal, corn, crushed stone, and steel scrap meet that criterion in the NS-CR analysis. The traffic lane movements of coal affected by NS-CR total over 11.7 million tons, more than the total combined tonnage for the 40 largest affected commodities in Dr. Pittman's Table II.

Destinations (Table V) Exhibits 4 and 5 identify the commodities at origin or destination most severely impacted by SF-SP and NS-CR respectively. The four commodities most affected at destination by NS-CR—coal, paper, corn and sheet steel—have combined tonnage almost equal to all ten of the largest commodities affected by SF-SP at destination.

EXHIBIT 4

COMMODITIES MOST AFFECTED BY SF–SP MERGER

[In thousands]

At origin	Affected tons	At destination	Affected tons
Sorghum	2,534	Corn	2,028
Corn	1,816	Liquid sulphur	1,796
Beer	1,712	Fiberboard	1,762

[5] The exhibit was not reproductible and is in the committee files.

COMMODITIES MOST AFFECTED BY SF–SP MERGER—Continued

[In thousands]

At origin	Affected tons	At destination	Affected tons
Pulpwood	1,615	Sodium compounds	1,547
Barites	1,350	Plastics	1,417
Wine	1,079	Lumber	1,074
Glycols	700	Newsprint	1,067
Coke	641	Broken stone	928
Soybean cake	605	Beer	854
Cement	508	Sorghum	806
Top 10 total	12,560		13,279

EXHIBIT 5

COMMODITIES MOST AFFECTED BY NS–CR MERGER

[In thousands]

At origin	Tons	At destination	Tons
Corn	8,378	Coal	4,114
Sheet steel	7,650	Paper	3,900
Auto parts	5,141	Corn	3,280
Steel ingots	4,765	Sheet steel	2,916
Set up autos	4,550	Plastics	2,742
Paper	4,421	Steel scrap	2,506
Cyclic intermediates	2,138	Steel ingots	2,107
Steel pipe	2,117	Iron ore	1,994
Pulp	2,082	Auto parts	1,829
Corn syrup	1,844	Steel bars	1,630
Top 10 total	43,086		27,010

Orgins (Table VII) The ten commodities most affected by NS–CR at origin have over 43 million impacted tons-over 242% larger than the comparable total for SF–SP's ten largest affected commodities. In both SF–SP and NS–CR cases, the commodites most affected by rail mergers are, not suprisingly, those most dependent on the rail mode.

Exclusively Served Markets. (Table IX) Dr. Pittman's testimony identifies coal, copper ore, corn, sodium compounds and cement as the commodites most vulnerable to SF–SP control. Coal, crushed stone, piggyback traffic, iron ore and steel scrap are the commodities most vulnerable to possible NS–CR control. However, while only two SF–SP commodites have over 1,000,000 affectd tons. 18 NS–CR commodities have over 1,000,000 tons.

COMPARISON OF DOJ ANALYSES OF NS–CR AND SF–SP CASES

The Department of Justice chose an analytical approach in the NS–CR case that differed markedly from that employed by Dr. Pittman in the SF–SP case. At this point, the limited documentation available from the DOJ describing their NS–CR analysis makes it impossible to fully understand every facet of their approach. As a rule, it seems that the DOJ in NS–CR used a very fine screening process in order to arrive at findings that support a divestiture recommendation. Dr. Pittman offered very few prescriptive conclusions in his testimony. Indeed, the Department of Justice has yet to make a definitive ruling on SF–SP.

The DOJ analysis of NS–CR was in every way more limiting than that used by Dr. Pittman.

The DOJ's geographic area in NS–CR was the country; Pittman used larger Business Economic Areas.

In NS–CR, DOJ analyzed only origin and destination markets, Pittman also studied origin-destination traffic lanes.

IN NS–CR, DOJ screened out market areas controlled by another raliroad eg. BN in eastern Montana; Pittman did not use this screen.

DOJ screened small markets (under $2 million) from consideration in NS–CR, e.g. Ford Motor in Wayne County, it screened out that county; Pittman had no comparable exclusion rule.

Present NS or CR monopoly markets eg. New York City were excluded by DOJ; Pittman examined exclusively served markets separately.

An intermodal competition screen was used in NS–CR; Pittman used evidence of intermodal competition as a check but not as a screen.

I do not have enough evidence to determine whether the DOJ's analysis of the NS–CR combination is better or worse than Pittman's SF–SP analysis. Certainly, the DOJ analysis in the SN-CR case differs radically from Dr. Pittman's. The use of counties, the $2 million volume screen, and shipper support (rather than opposition) to NS–CR has the inevitable effect of greatly reducing the scope NS–CR's anti-competitive impacts. Without additional documentation and a fuller explanation of their rationale, the analytical approach chosen by DOJ to study NS–CR remains open to question. The skepticism that surrounds the DOJ's findings on NS–CR can only be removed by a more complete explanation of the DOJ's approach and recommendations. In addition, the Department must explain why such radically different approaches were taken to analyze to rail mergers.

[MEMORANDUM]

To: Gordon E. Neuenschwander, Pittsburgh & Lake Erie Railroad Company.
From: Randal C. Teague, Howard A. Vine.
Date: June 4, 1985.

Pursuant to your request, we have reviewed the proposal for a private sale of Conrail advanced by the investor group organized by Morgan Stanley. Our review had been limited exclusively to the proposal's recommended management structure. In our view, the structural form selected for the "private" Conrail will establish whether or not the Morgan Stanley proposal truly results in a private shareholder directed company.

The Morgan Stanley proposal offers a curious directoral structure for a publicly held corporation. First, Morgan Stanley proposes that upon privatization, Conrail shall have a "constituency" board of directors, not at the nomination of private shareholders but at the insistence of Congress. Congress has never officially sanctioned such a board of directors for a publicly held corporation. To do so would jeopardize the independence of the director's judgments and persent the likelihood for conflicts of interest. Indeed, to mandate such a structure is to remove from the free will of the shareholder the directioral franchise essential to such a corporation.

Second, the proposal structures two critical committees of the board of directors which will serve as the operational power centers for the "private" Conrail. They are the Executive and Finance Committees. Yet, no "rail" shareholder may cast votes for the membership of such Committees or ever serve on the Board's all-important Executive Committee. Accordingly, even though the Executive Committee will be the launch for all board nominations, major shareholders will have little influence over management. Similarly, we fear, management need not be responsive to those holding major financial interests. The proposed structure for the Finance Committee also is problematic. The Finance Committee will have 5 directors, 4 to be drawn from the shareholders and 1 guaranteed seat to be filled by Morgan Stanley itself. this guarantee to Morgan Stanley, of a seat on the Board and on the Finance Committee, seems to be an excessive degree of compensation to the private Contrail's "Agent". Moreover, although a rail shareholder is not permitted a seat on the Board of Directors, the proposed charter would permit a rail company to hold a seat on the Finance Committee; another curious inversion of shareholder democracy.

Third, pursuant to the proposed charter, shareholders have absolutely no independent voice with respect to dismissal of any shareholder director proposed to be dismissed by the Executive Committee. Section 4.07 of the Morgan Stanley Shareholder Agreement notes that "each shareholder agrees to vote all of the shares . . . for the removal of any Shareholder Director if such removal has been approved by the Executive Committee." This requirement also applies to nominations of the Executive Committee (See, Section 4.01). Thus, any and all nominations or motions for dismissal by the Executive Committee are absolute and not subject to objections or the casting of votes against such a recommendation. This proposal absolutely disenfranchises the shareholders from any substantive voting.

Management's accountability to shareholders is clearly in jeopardy when management entrenches itself against effective oversight. In our view, Sections 4.01 (Election of Directors), 4.02 (Executive Committee), 4.03 (Powers of the Executive Committee), 4.07 (Removal of Directors), and 4.09 (Election of Executive Committee and Finance Committee) potentially combine to provide a prescription for management entrenchment in the hands of the Committees of the board. As proposed, shareholders will imbue the Executive Committee with absolute power to nominate and remove all directors. This abolute power delivers to the five member executive committee authority to control the direction of the corporation immune from the control interests of its shareholders. The Finance Committee will enjoy similar immunity.

It would be most unusual for Congress to sanction the foregoing management structure proposed by Morgan Stanley. To permit a company to enjoy a protected Status, unique and above the grants provided (and standards of conduct demanded of) other privately held enterprises, is to sanction a form of governance which must be, one would assume, descriptive of Congress' perfect corporate form. Congress has neither reached such an understanding as to the "best" management form, nor expressly sanctioned that the privatized Conrail should enjoy any special status. To the contrary, Congress has determined that Conrail should compete on terms equal to all private rail carriers. To adopt the management structure offered under the Morgan Stanley proposal would be to experiment with a form of corporate governance which disenfranchises shareholders, entrenches management and upends commonly held notions about governance and accountability.

NORTHWEST RAIL IMPROVEMENT COMMITTEE,
Everett, WA, June 9, 1985.

The UNITED STATES SENATE,
Committee on Commerce, Science, and Transportation,
c/o Hon. Jack Danforth, Chairman, Washington, DC.

GENTLEMEN: The Northwest Rail Improvement Committee requests that the sale of Conrail to the Norfolk Southern be viewed in the light of the following history:

In the 18th century the residents of what is now the United States of America were struggling to carve out of both the physical and political wildernesses a way of life whose freedom would enable them to develop a standard of living far more satisfying than was possible under the traditional European rulers. Among their chief opponents were the British Crown in conjunction with the controllers of certain international trading cartels and bankers, whose policy was to hold colonies as sources of cheap raw materials and handmade goods to bolster the wealth of the mother country; particularly its ruling class. Success of that policy depended on keeping the colonists in a state of servitude, which was possible only by preventing rise of the technology, education and philosophy which would support independent self-government.

The successful revolt of 13 American colonies in establishing an independent nation dedicated to an opposite philosophical, economic and political system was a severe shock to the ruling classes of both Britain and continental Europe. They reacted by taking immediate steps to make that new enterprise fail. To that end they fomented the War of 1812. Upon its failure they sought to divide the new country by selling African slaves to the southern portion while propagandizing the north to oppose slavery. Upon failure of the resulting Civil War they sought to subvert the country from within by undermining its political and economic system. To that end European despots sent their special financial agents John Pierpont Morgan of the British Morgan family of international bankers and Jacob Schiff of the continental Rothschild family to set themselves up as prestigious Wall Street bankers.

Morgan and Schiff (who were later joined by John D. Rockefeller) then proceeded to finance American railroads and then to destroy free enterprise in that sector and to gain leverage over the country's transportation by foreclosing on loans and otherwise instigating mergers of small railroads into giant systems under their own control. They sailed forth to destroy as much free enterprise as possible in other industries, too, by similarly fomenting mergers into such monopoly-oriented giants as American Telephone and Telegraph, International Harvester, United States Steel, General Electric, General Motors, etc. (always under control of themselves or their cohorts), and also to undermine our political system by training their own agents in the art of getting themselves elected to public offices.

Then in 1913 they consummated what is probably their greatest single act of treason by bringing the whole American banking system, and the Federal currency as

well, under their control by authority the Federal Reserve Act and having their agents in Congress bulldoze it into passing.

Thus, by examining the record we find that the long-enduring economically decrepit condition of our railroads, as well as the economic decrepitude of our whole country in the 1930's and at the present time, have been caused by the anti-American financial and political manipulations of those agents of foreign despots whose objective for 200 years has been to bring our country back under the same control from which our forefathers won independence as of July 4, 1776.

The present-day firms of Morgan Stanley, Lehman Brothers, Kuhn Loeb, Shearson/American Express, Goldman Sachs, Chase Manhattan, among others, are direct members and associates of the families who have received their training, philosophy, methodology and objectives from the Morgans, Schiffs, Rothschilds, Warburgs, and their allied European royalty who for dozens of generations have been the archenemies of the American system of government and economy.

On this basis we submit the prediction that the sale of Conrail to the Morgan-controlled Norfolk Southern will one day go down in history as one of the many acts of treason which helped to administer the coup de grace to the United States of America as it was known during 200 years of the greatest renaissance the world had ever known.

Is it too late to hope that this prediction will not come true?

Respectfully submitted,

NORTHWEST RAIL IMPROVEMENT COMMITTEE,
GORDON W. ROGERS, *Chairman.*

AFMA,
June 12, 1985.

Hon. JOHN C. DANFORTH,
Chairman, Senate Committee on Commerce, Science, and Transportation, 508 Dirksen Senate Office Building, Washington, DC.

DEAR CHAIRMAN DANFORTH: The American Feed Industry Assn. (AFIA) is concerned about the possible sale of the federal government's 85 percent interest in Consolidated Rail Corp. (Conrail) to the Norfolk Southern Railway. AFIA respectfully requests this letter be included in the hearing record of June 12, 1985, when the committee heard testimony from Morgan Stanley Co., and others relative to the proposed sale of Conrail to a private investor group.

AFIA is the national trade association representing the manufacturers of more than 70 percent of the primary formula livestock and poultry feed sold annually in the U.S. AFIA's membership also includes those companies providing ingredients and services to feed manufacturers. The domestic feed industry annually buys $10-15 billion worth of feed ingredients, making it the largest single domestic user of U.S. grain and grain byproducts. As such, AFIA has a long-standing interest in transportation matters affecting its members. The Conrail sale is such a matter.

AFIA's concern centers on continued rail competition in the Northeast and lower Great Lakes territory served by the Contrail system, and the likely disappearance of that competition if the federal government should approve the sale of Conrail to Norfolk Southern.

In May 1984, the AFIA Transportation Committee appointed a task force of member companies in the territory served by Conrail to review the 14 bids received by the Department of Transportation to purchase Conrail. The task force arrived at the following conclusions, which were communicated to secretary of Transportation Elizabeth Hanford Dole on August 1, 1984:

1. AFIA was disappointed in the Department of Transportation's refusal to hold a Section 401 hearing within the Conrail operating territory as a means of more precisely identifying shipper and existing carrier interests in the controlled transfer of Conrail to another entity.

2. Due to this lack of shipper/carrier input, AFIA urged DOT to give the strongest preference to non-carrier bids for the purchase of Conrail. Our letter to Sec. Dole stated: "This will avoid the possible creation of an undesireable monopoly rail system within New England and the lower Great Lakes that could lead to the eliminaiton of competitive bidding and alternate rail transport for agricultural shippers in those areas."

3. AFIA urged strongly that DOT re-evaluate the value of Conrail properties prior to accepting any bid. AFIA cited the evaluations of Goldman Sachs & Co., and its evaluation of approximately $1 billion, as being in serious conflict with the Morgan Stanley evaluation of $2.5-3 billion.

The sale of Conrail to the Norfolk Southern is a two-edged sword. While a combined system would no doubt extend single-line access to some markets, it would inevitably end current more competitive single-line for many shippers, including those shipping out of the lower Great Lakes into the mid-Atlantic and New England regions. The New England feed industry, operating in a grain-deficit region, relies heavily on competitive rail service to supply it with bulk ingredients and for shipment of some finished product to other markets. The increase in transportation costs that would result from the loss of competitive rail service would inevitably be reflected in the cost of feed products to the region's dairy, livestock and poultry producers and ultimately in the cost of meat, milk and eggs to consumers.

The potential sale to the Norfolk Southern could also result in the abandonment of current competitive service between Norfolk Southern and Conrail that now exists in some markets. That service has continued essentially because competition forced it. The loss of such competition and the discipline that competition imposes on price and service would be a severe loss to the agricultural shippers in the Conrail service area.

The concern of Congress during its deliberations over the sale of Conrail should not center on which buyer can most readily come up with the $1.2 billion that DOT says Conrail is worth, but rather which buyer can provide the strongest assurances of the long-term operational health of Conrail. We believe Conrail and its management has effectively demonstrated its ability to run an efficient, profitable, competitive railroad.

The management of Conrail has taken a near-bankrupt system in the mid-1970s and created a viable rail carrier. In 1984, Conrail posted profits of more than $500 million, and has cash reserves of nearly $900 million.

Conrail management though its actions and testimony before Congress has demonstrated its commitment to continued investment in the system and customer service. Conrail has disposed of unprofitable lines and upgraded its equipment and track. The concern of members of this committee and Sec. Dole that Conrail be transferred to an entity that can assure Conrail's survival during any future economic downturn so as to avoid possible government bail-out is justified. However, Conrail management has demonstrated that ability. In addition, the current deregulated environment enjoyed by railroads allows freedom to innovate and adapt to changing economic conditions as demonstrated by the general profitability of most Class I carriers today as contrasted with the 1970s.

The basic issue then is competition and the continued ability of shippers in the Conrail operating territory to obtain the best service at the best possible rate. A merger with Norfolk Southern would create a 30,000-mile system on the Eastern Seaboard extending as far south as New Orleans, as far west as Des Moines, Iowa and north into Canada. It would remove a major carrier from the rail system, leaving the nation with only five major carriers.

AFIA is concerned that this lack of competition will lead to more shippers lumped into that unenviable classification of "captive." The challenge that your committee must face is to preserve competition, thus allowing deregulation to work.

Sincerely,

STEVE KOPPERUD,
Vice President—Legislation.

The following questions were submitted to the Morgan Stanley investors and their responses follow.

1a. Why are you investing in the Morgan Stanley proposal to purchase Conrail?

b. How much in dividends do you expect to be paid annually?

2a. Have you analyzed Conrail's financial projections, such as those on traffic, earnings and net cash flow?

b. In view of these projections, why do you think that Conrail can afford to pay dividends, which represent an initial yield far in excess of the current dividend yields of all other major railroads?

c. If Morgan Stanley's financial projections are not realized, are you prepared to invest additional sums in Conrail to make up any cash deficit?

d. If you are not prepared to invest such additional sums, how would yo expect Conrail to make up the cash deficit?

3. How long do you intend to hold your stock interest in Conrail?

4a. What are the terms of the commitment letters you signed with Morgan Stanley?

b. What is your understanding of your options for pulling out of the proposal both before and after closing on the sale with the Federal Government?

c. Would Morgan Stanley have any legal recourse against you for refusing to honor your commitment letter?

d. Would the other investors be required or have they already volunteered to make up the difference if you pull out?

AMERICAN INTERNATIONAL GROUP, INC.,
New York, NY, July 12, 1985.

Senator JOHN C. DANFORTH,
U.S. Senate, Committee on Commerce, Science, and Transportation, Washington, DC.

DEAR SENATOR DANFORTH: Our response to the questions posed in your letter of July 2, 1985 regarding American International Group's role in the Morgan Stanley proposal to purchase Conrail follows:

1a. Conrail's financial performance since 1981 demonstrates the system's normal earning power to exceed $300 million or $10 per share after a full tax burden. Resulting cash flow should finance appropriate capital expenditures, provide for scheduled debt retirement and support dividends on the common stock approximately $120 million per annum or $4 per share. The prospective investment return from such dividends and a capitalization of Conrail's earning power in line with that accorded other railroad equities in the public stock market present a compelling investment case in our judgement.

b. At least $4 per share per annum.

2a. Yes.

b. Prospective dividends are a function of Conrail's current and future earning power and not related to the dividends paid by other major railroads or to the values placed thereon.

c. No.

d. By reducing dividend payments and capital expenditures, rescheduling debt retirement and effecting whatever cost control, asset redeployment or other means are at the disposal of management.

3. Until such time as its liquidation is legal and in keeping with the "Shareholders' Agreement" included as Attachment A of the Morgan Stanley proposal and when such liquidation is deemed appropriate in light of Conrail's financial performance and overall market conditions.

4a. The commitment to invest $35 million is subject to various conditions including enactment of appropriate legislation to authorize the transaction, satisfactory arrangement with Conrail's Agreement Employees, an effective Registration Statement, negotiation of a definitive purchase agreement, lack of any material adverse changes and approval by our counsel.

b. As noted, our commitment is subject to various conditions which must all be met.

c. We assume Morgan Stanley would attempt to pursue appropriate remedies if they felt that the conditions to the commitment were met and we failed thereafter to honor the commitment.

d. No.

We hope this information will prove helpful in your deliberations and continue to urge your favorable consideration of the Morgan Stanley proposal. If we can be of any further assistance to you or the Committee, we would be delighted to do so.

Sincerely,

RICHARD B. GOODWYN,
Vice President—Domestic Investments.

AMERICAN FAMILY,
Madison, WI, July 11, 1985.

Hon. JOHN C. DANFORTH,
Chairman, Committee on Commerce, Science, and Transportation, U.S. Senate, Washington, DC.

DEAR SENATOR DANFORTH: Enclosed are American Family Mutual Insurance Company's responses to the questions which the Commerce Committee prepared for each

of the members of the Morgan Stanley investor group formed to purchase Conrail from the United States Government.

American Family appreciates the opportunity to provide this information to the Commerce Committee and offers its full cooperation in this matter.

Sincerely,

PAUL L. KING,
Vice President, Investments.

Enclosures.

RESPONSES TO QUESTIONS

1a. Why are you investing in the Morgan Stanley proposal to purchase Conrail?

American Family Mutual Insurance Company is willing to invest in the Morgan Stanley proposal to purchase Conrail because the expected total return on the investment (from dividends and capital gains) is competitive with other investments, given the perceived level of risk.

b. How much in dividends do you expect to be paid annually?

While we hope that Conrail's dividend performance will achieve the levels targeted in the Morgan Stanley offering materials, we understand that actual dividend payments will depend upon Conrail's operating results and capital needs.

2a. Have you analyzed Conrail's financial projections, such as those on traffic, earnings and net cash flow?

We have analyzed the offering material supplied by Morgan Stanley, including separate projections by both Conrail and Morgan Stanley.

b. In view of these projections, why do you think that Conrail can afford to pay dividends, which represent an initial yield far in excess of the current dividend yields of all other major railroads?

Based upon our analysis of the railroad industry generally and Conrail in particular, we believe that Conrail's projections are quite conservative. Our research is consistent with that of Morgan Stanley, and our conclusion is that Conrail should be able to attain the dividend performance projected by Morgan Stanley. Again, it should be emphasized that we understand that actual dividend levels will depend upon operating results, and our investment decision was made with an appropriate allowance for that fact.

c. If Morgan Stanley's financial projections are not realized, are you prepared to invest additional sums in Conrail to make up any cash deficit?

Our willingness to invest additional sums in Conrail at some future date would depend upon conditions existing at that time.

d. If you are not prepared to invest such additional sums, how would you expect Conrail to make up the cash deficit?

While we do not foresee such a cash deficit, we are willing to defer to the judgment of Conrail's management as to how such a deficit can best be eliminated. To that end, we assume that management would carefully consider all available options, including expense reduction, additional borrowing, deferral of discretionary debt repayment, and dividend reductions.

3. How long do you intend to hold your stock interest in Conrail?

The Morgan Stanley proposal envisions that all members of the investor group will enter into an agreement which will effectively restrict each individual investor's freedom to decide how long to hold its Conrail stock. We are prepared to enter into such an agreement, and view it as one of the risks to be assumed by us by a member of the investor group. Beyond the terms of the proposed agreement, we have not yet decided how long we intend to hold the Conrail stock.

4a. What are the terms of the commitment letters you signed with Morgan Stanley?

We are informed that you have already received a copy of our Letter of Intent addressed to Morgan Stanley.

b. What is your understanding of your options for pulling out of the proposal both before and after closing on the sale with the Federal Government?

We have not previously considered options which would permit us to withdraw from the investor group. However, our understanding of the mechanics of the Morgan Stanley proposal is that all of the conditions to participation imposed by the various investors would be satisfied prior to any closing with the Federal Government, so that withdrawal thereafter by any investor would be practically impossible.

c. Would Morgan Stanley have any legal recourse against you for refusing to honor your commitment letter?

We signed our Letter of Intent in good faith, and we expect to perform accordingly. Moreover, our counsel advises that, upon satisfaction of all conditions stated

therein, the Letter of Intent would be a legal obligation, with all resulting implications.

d. Would the other investors be required or have they already volunteered to make up the difference if you pull out?

We have no knowledge of Morgan Stanley's present arrangements with other investors.

RESPONSE OF CITICORP CAPITAL INVESTORS, LTD. TO QUESTIONS DATED JULY 2, 1985 FROM THE CHAIRMAN OF THE SENATE COMMERCE COMMITTEE

(1.)(a.)

As was indicated in our testimony before your Committee on June 12, Citicorp has been involved in the evaluation of Conrail since December 1983, when we began to investigate the possibility of making an offer for Conrail. We were one of the 16 bidders for Conrail in June 1984.

Our view then and our view now is that Conrail is a sound and attractive investment as a viable, stand-alone operating entity. The major reasons behind our view are that:

Management has been able to effect a turnaround of major proportions, from a loss of $400 million in 1978 to a profit of $500 million in 1984, and has been able to show constant improvement despite such obstacles as the major 1982-83 recession.

The right-of-way and equipment of Conrail is in first class condition. Conrail is now, and will be after the transaction we propose here, the only Class I railroad in the United States without mortgage indebtedness on its right-of-way or any other indebtedness other than normal equipment financing.

USRA's projections and those of Morgan Stanley, with which we concur, indicate that Conrail will be able to continue profitable operations over the foreseeable future, even when substantial recessions are taken into account.

Finally, because of the above reasons, the Conrail investment proposed by Morgan Stanley offers a reasonable and acceptable rate of return to the long-term investor.

You should also be aware, of course, that Citicorp has substantial lending positions in companies throughout the Northeast, many of which rely on a strong and viable Conrail. Our investment in Conrail helps strengthen this existing significant, long-term involvement in the industries of the Northeast.

(1.)(b.)

The financial projections of Morgan Stanley (supported by data from Conrail) suggest a dividend payout ratio of 37% of projected earnings. This payout ratio is consistent with the practice of most other large railroads, including Norfolk Southern (44%), Santa Fe (38%), Union Pacific (45%), and CSX (37%). This projection translates into a cash flow payout ratio of 14%, which compares to Norfolk Southern's 22% ratio. These projections are also consistent with the "public interest" covenants required by DOT.

Based on our review of Conrail's future, as well as USRA's and Conrail's analyses, we are confident that this dividend level is attainable, taking into account the full capital spending level forecast by Conrail management, not simply the $350 million minimum annual level required by DOT's covenants.

The Committee should keep in mind, of course, that dividend levels are set by the Board of Directors, who have fiduciary responsibilities, and are in no way assured to any investor. If the Board finds that Conrail's business won't sustain these dividend levels, it will reduce them, and the investors are entirely at risk.

(2.)(a.)

As noted above, Citicorp has been invovled in a detailed evaluation of Conrail financial projections since the end of 1983.

(2.)(b.)

We believe that the thrust of the question is incorrect, since it evaluates yield without taking into account the public offering process mandated by the Morgan Stanley proposal. When Conrail stock is fully distributed through the offering process, we anticipate that yield will be comparable with the yields of the other major railroads, including Conrail's principal competitors, Norfolk Southern (5%) and CSX (4.8%).

(2.)(c.)

We must reiterate again that our evaluation of Conrail's financial projections indicates that they are conservative and Conrail will be able to meet them. Because

its right-of-way and equipment is now in first class condition, and it is the only Class I railroad in the country without mortgage indebtedness on its right-of-way or any other indebtedness other than normal equipment financing, Conrail will have a prime credit rating, and will be able to obtain financing if required. In light of those factors, should shortfalls develop from Morgan Stanley's projections, we are prepared to assist in providing further financing for Conrail.

(2.)(d.)

As discussed in question (2.)(c.), we are prepared to provide further assistance to Conrail. We should further emphasize that because of its lack of indebtedness, and the unencumbered value of its assets, Conrail is in a unique position in the railroad industry in its ability to obtain assistance from financial institutions, even if further investment funds were somehow unavailable. The strength of Conrail in this regard should not be underestimated.

(3.)

As the Committee is aware, the investors participating in the Morgan Stanley proposal are required under the terms of the offer to relinquish a major portion of their investment over time in order to meet the goal of a truly public offering and to achieve a widely-held public company. Concerning the remainder of its holdings, aside from those mandated reductions, Citicorp is a long-term investor, and is not interested in a short-term gain. We believe that the full value of our investment will only be attained from the long-term financial viability of Conrail, and we are committed to a long-term involvement in the company.

(4.)(a.)

The Committee has already received a copy of our commitment letter from Morgan Stanley.

The commitment letters entered into are a standard practice in the investment community, and full reliance on such letters is a fundamental procedure in that community. The commitment letters were entered into seriously, in good faith, and are legally binding, and we can assure you that Citicorp and the other investors have no intention of abanadoning them. To put it frankly, the understanding and practice of the investment community is that you cannot back away from such commitments if you want to continue to do business in that community.

Even should some funding fail to materialize—and this will not occur—the Conrail offer by Morgan Stanley is already completely oversubscribed and obtaining back-up funds will not be a problem.

COLUMBIA UNIVERSITY IN THE CITY OF NEW YORK,
New York, NY, July 22, 1985.

Hon. JOHN C. DANFORTH,
Chairman, Committee on Commerce, Science, and Tranpsortation, U.S. Senate, Washington, DC.

DEAR SENATOR DANFORTH: Thank you for your letter of July 2, 1985 and list of questions concerning the proposed Morgan Stanley group investment in Conrail.

The questions in many ways are not really consistent with the investment process used by Columbia in evaluating a proposed investment, but I will answer them in general terms.

1. Columbia is willing to invest in this proposal because on balance it appears to offer a long-run total rate of return that is suitable at acceptable levels of risk. Dividends would parallel those of other railroad stocks over a long period of time.

2. Projections are only a part of any investment decision. We feel that a financially revitalized Conrail, in which the employees already hold a significant interest, should be a very competitive long-term investment, especially given the location of its markets.

3. We would hope to hold an investment in Conrail for a long period of time, understanding that we may be required to sell a portion of it to a broader group of investors in the future.

4. It is my understanding that all the commitment letters have been made available to the Committee. In answering the subquestions I will simply say Columbia intends to honor its commitment and follow through should the proposal come to fruition, unless some material changes were made in the proposal which would alter substantially the investment risks involved.

If you or any member of your Committee would like to discuss this further, we would be more than happy to meet with you.

Sincerely,

CHARLES G. DYER,
Vice President for Investments.

COMPAGNIE DE BANQUE ET D'INVESTISSEMENTS,
Genève, July 18, 1985.

Hon. JOHN C. DANFORTH,
U.S. Senate, Committee on Commerce, Science, and Transportation, Washington, DC.

DEAR SENATOR DANFORTH: We are in receipt of your letter dated July 2, 1985, which arrived at our offices on July 12, the date requested for response. We apologize for the delay but following are the answers to the questionnaire attached to your letter:

1a. We have come to understand the railroad business in the U.S. through significant investments we have made in this industry since several years. We believe that this industry presents particularly attractive long-term opportunities. In Europe, we have participated in most new issues involved in the privatization of industry and, in this specific instance, we believe the risk-reward ratios to be attractive.

1b. We have been in business long enough to know that one cannot "expect" any particular level of dividends, especially, in a cyclical industry. We cannot conceive how one can come to "expect" any dividend level until Conrail has had a long period of successful operating experience as a private company.

2a. Yes, to our satisfaction.

2b. We are comfortable that Conrail will be able to pay a dividend based on the projections we have received. As in any private corporation, the dividend level will depend on the policy set by the Board of Conrail and could conceivably be different from what is projected. One cannot forecast its relative level as of now.

2c. As in any investment, we will review our position at the time such an event would arise. Given the prospect for Conrail's future as a private company, we would expect that, should such an event occur, we will in all probability be inclined to participate.

2d. We expect that Conrail will have full access to the public and private markets for additional capital.

3. We expect to hold this investment until such time as the company's prospects and market price suggest we dispose of our holding.

4a. We are given to understand that your Committee has received a copy of all the commitment letters.

4b. Unless there are substantial changes to the terms and conditions of the proposal, we do not, at this time, anticipate withdrawal from our commitment.

4c. We have not explored this matter and the possibility of our refusing has not been addressed since we consider the probability very remote.

4d. We understand that the deal is over-subscribed and that any short fall could easily be filled.

Hoping that the above answers will contribute measurably to the deliberations and reviews of your Committee.

Yours sincerely,

COMPAGNIE DE BANQUE ET D'INVESTISSEMENTS.

CHESSIE SYSTEM RAILROADS,
July 15, 1985.

Hon. JOHN C. DANFORTH,
U.S. Senate, Committee on Commerce, Science, and Transportation, Washington, DC.

DEAR SENATOR DANFORTH: Hays Watkins, our Chairman, has asked me to respond to the questions contained in your letter of July 2, 1985, and I am enclosing responses. If you have any further questions, please do not hesitate to call me.

Sincerely,

JOHN W. SNOW,
President and Chief Executive Officer.

Enclosure.

1a. and b. We are investing in the Morgan Stanley proposal for two reasons. First, the Morgan Stanley proposal would preserve an independent and competitive Conrail. In comparison, as we have testified several times, a sale of Conrail to Norfolk

Southern would be the most anticompetitive combination in the history of the transportation industry. Second, we believe that Conrail is viable, will be viable, and that our investment will provide us a very fair return. In terms of the return, we do not have an intention of retaining the Conrail stock over the long run, and we have made provisions to totally insulate CSX from any control of Conrail. Therefore, we would anticipate some dividends in accord with the Morgan Stanley proposal, but that the bulk of our return would come from the sale of the stock.

2a. We have analyzed Conrail's financial projections, and believe that Morgan Stanley's analysis is quite reasonable. Earlier, as the Senator and others have pointed out, we had a more pessimistic view of the general rail situation in the Northeast and of Conrail's long-range future. We still have certain concerns about rail traffic in the Northeast, but Conrail's recent performance has shown that it can be quite successful in a situation where traffic is flat or in fact declining. In our previous analysis, we had not taken fully into account the change in Conrail management, the enormous strides Conrail has made to restructure its work force and plant, and Conrail's ability to take advantage of the reforms of the Staggers Act. All these changes have made Conrail a very different company.

b. In terms of dividend yields, we agree with Morgan Stanley that projected yields are not in any way out of line with yields provided by other railroads. A copy of the Morgan Stanley letter of July 1 is attached, which provides more detail relating to this matter.

c. As for additional investments, our belief is that Conrail will be successful. In the unlikely event that it is not, we, like any other investor or company, would have to make an assessment of whether further investment are in order. Norfolk Southern would have to make exactly the same analysis, and obviously in the past with respect to several railroad purchases such as the Erie Lackawanna and the D&H, decided not to make further investments.

d. Again, we do not anticipate any cash deficit, and so once again, in the very unlikely event that should occur, we, along with all the other investors, would have to look at the usual alternatives available including further investment.

4a. and b. Our commitment letter is in the form requested by Morgan Stanley. We consider it a firm commitment. The letter specifies that our commitment is subject to the enactment of appropriate legislation, a satisfactory agreement with labor, the signing of a satisfactory agreement with DOT, and approval by our counsel. The commitment expires on December 31, 1985.

c. As indicated, we consider our commitment to be firm and bining, in accordance with the terms of the letter.

d. We have no intention to "pull out."

DARTMOUTH COLLEGE,
Hanover, NH, July 11, 1985.

Hon. JOHN C. DANFORTH,
Chairman, Committee on Commerce, Science, and Transportation, 497 Russell Senate Office Building, U.S. Senate, Washington, DC.

DEAR SENATOR DANFORTH: This letter is in response to your request of July 2, 1985.

The Dartmouth College Trustees' Investment Committee has concluded that Conrail is a viable corporation representing an attractive long-term investment opportunity. This assessment is based on our confidence in Conrail's management, our perception of its financial situation as represented by Morgan Stanley, others familiar with the industry, and on our own review. Conrail will provide added diversity to our portfolio in an area which we feel has the potential for a satisfactory overall total return.

We expect dividends to be paid in accordance with industry trends and standards; initially such dividends should be comparable to returns in the money market for short-term maturities.

We have analyzed Conrail's projections and we believe that a publicly traded Conrail common stock has the potential to appreciate to the valuation range of other railroads. This would bring the yield in line with that of Conrail's eastern competitors. Of course, we do recognize that if Conrail's business cannot sustain the planned level of dividend, then a reduction will likely occur.

Investing additional sums in Conrail depends upon numerous variables. Our analysis in the future would be similar to that of any other investment opportunity competing for Dartmouth's limited resources. Regardless of our own conclusion on future funding, we believe Conrail will be well positioned to make up any cash deficit through the public markets or conventional sources of borrowing.

It is the Investment Committee's intention to hold Dartmouth's stock interest in Conrail as long as it appears to be an attractive investment.

I understand that Morgan Stanley has already provided you with the terms of the commitment letter which has been signed. Dartmouth College intends to honor its commitment as we would to any other comparable investment proposal once the outlined conditions have been met.

Sincerely yours,

PAUL D. PAGANUCCI,
Vice President and Treasurer.

DIGITAL EQUIPMENT CORP.,
Weston, MA, July 17, 1985.

Hon. JOHN C. DANFORTH,
Chairman, Commerce, Science, and Transportation Committee, Room 428 Hart, Washington, DC.

DEAR SENATOR DANFORTH: Thank you for granting us an extension to your timetable due to my vacation schedule.

Our investment in Conrail is the result of our favorable assessment of the railroad industry, and Conrail's restoration to profitability and outlook for continued growth. We have owned railroad securities for many years and are comfortable with Morgan Stanley's projections and outlook for the company and industry. The projected pricing of the stock appears to be on attractive enough terms to allow for the profit potential we desire for our portfolio investments and the risks involved. We are impressed with the job Conrail's management has done and the consequent financial strength.

The proposed dividend policy looks to be in line with industry standards, most specifically in terms of the payout ratio. We would anticipate that the current yield would decline from the seemingly high initial level as a result of a higher stock price. We view dividends as part of the overall total return potential for our investment. Should dividend policy be too liberal, this becomes reflected in a company's financial position and ultimately in a lower valuation for its stock. We do not believe this to be the case with Conrail.

The projections allow for the stated dividend policy. However, should conditions change for the worse, Conrail's Board of Directors will have to judge the merits of the existing dividend, as with any company. While we do not expect to invest additional funds in this security, we believe Conrail's financial position allows room for assuming substantially more debt should the need for cash arise.

Our time commitment for this investment is comparable to all securities in our universe. We are basically long-term investors, departing from this overall policy only when market conditions change or individual investments become overvalued relative to their potential.

Our commitment letter with Morgan Stanley states that we will invest up to $10 million toward the purchase of the 85% Conrail block, subject to the passage and signature into law of appropriate legislation to authorize the transaction, a satisfactory agreement with Conrail's employees, an effective registration statement, the negotiation statement, the negotiation of a definitive purchase agreement with the U.S. Department of Transportation exhibiting substantially the terms set forth in the Invitation to Investors dated April 18, 1985 and lack of any material adverse changes.

We understand our options for pulling out before and after closing on the sale with the Federtal Government. We consider them both the same. Since we signed a binding agreement we understand that there could be recourse against us for breach of contract to the extent that a replacement investor is not found and damages are incurred. We have always fulfilled our legal commitments and intend on so doing with this investment.

We are not aware of the ramifications of our pulling out on other investors.

Please let us know if you have further questions.

Sincerely,

ROBERT J. WHITEHEAD,
Corporate Investment Manager.

DIVERSIFIED CAPITAL,
Chicago, IL, July 30, 1985.

Hon. JOHN C. DANFORTH,
U.S. Senate,
497 Russell Senate Office Building, Washington, DC

DEAR SENATOR DANFORTH: Your letter dated July 2, 1985 to Allen Turner, trustee-partner of Diversified Capital, has been forwarded to me for a response. Before seeking to answer your queries with respect to our involvement in the proposal of Morgan Stanley & Co. Incorporated to form a group to purchase the 85 percent interest of the United States of America in Conrail Corporation, please permit me to apologize for this tardy response.

We first considered making a substantial investment in Conrail Corporation in mid-1984 when approached by representatives of unions having collecitve bargaining agreements with Conrail Corporation. In that context, we considered projections and other financial data prepared or compiled by such union representatives. Nothing of substance came of these early considerations, given the "bidding war" which developed in respect of Conrail Corporation.

When Morgan Stanley & Co. Incorporated approached us in the spring of 1985, we had some background into the Conrail Corporation situation. Based upon our analysis done in connection with the original approach by the union representatives and a more detailed analysis based upon information furnished to us by Morgan Stanley & Co. Incorporated, we concluded that Conrail Corporation presented an interesting and attractive investment opportunity to us, and we committed to invest $50 million upon the terms set forth in the attached letter of commitment.

You have questioned the amount of dividends that we expect to be paid on our investment in Conrail Corporation. Of course, the amount of dividends paid and the security of payment of such dividends is a principal factor in determining the value of any equity investment. In this regard, we believe that the projections of dividends to be paid by Contrail Corporation prepared by Morgan Stanley & Co. Incorporated appear consistent with the dividends paid by other major railroads and not out of line with the anticipated capital and other requirements of Conrail Corporation. Obviously, we assume that the management of Conrail Corporation will, in the future, continually assess the capital and other requirements of Conrail Corporation and adjust the payment of dividends in accordance therewith.

You have asked us whether if the projections on Conrail Corporation prepared by Morgan Stanley & Co. Incorporated are not realized we would be prepared to make additional investments in Conrail Corporation. First, we have no reason to believe that the projections of Morgan Stanley & Co. Incorporated will not be realized. Secondly, any decision as to additional investments would be dependent upon facts and circumstances then in effect.

With regard to your question as to how long we intend to hold our equity interest in Conrail Corporation, we can only respond that our investment objective is for long term capital appreication but, like any other investment, we will continue to reassess our investment in Conrail Corporation and act accordingly.

Quesitons 4(a) through 4(d) on the attachment to your letter of July 2, 1985 raise the issue of the bona fides of our commitment to make an investment in Conrail Corporation. While as a purely legal matter our commitment may not be enforceable, we do not take our commitments lightly and fully expect to fulfill our commitment in the event that the Morgan Stanley & Co. Incorporated proposal proceeds forward and is accomplished upon terms as heretofore described to us.

We believe the proposal of Morgan Stanley & Co. Incorporated to put together an investment group to acquire Conrail Corporation is unique in that it accomplishes the goal of the United States of America to denationalize Conrail Corporation in a responsible fashion and without antitrust complications or any disruption of the labor force of Conrail Corporation.

We trust this letter is responsive and helpful.

Very truly yours,

HAROLD S. HANDELSMAN.

THE DREYFUS CORP.,
New York, NY, July 11, 1985.

Hon. JOHN C. DANFORTH,
Chairman, Committee on Commerce, Science, and Transportation, U.S. Senate, 497 Russell Senate Office Building, Washington, DC.

DEAR SENATOR DANFORTH: In response to your letter of July 2, 1985, we are pleased to provide the following answers to your questions:

1. (a) We are participating in the Morgan Stanley proposal to purchase Conrail because we feel that the revitalized railroad property offers the potential of increased value in the near future. We believe our investment will have the strong possibility of future profitability and that the investment risks are reasonable ones to take and not dissimilar to any investment in the railroad industry.

(b) We anticipate that a dividend return of between 8 percent and 10 percent on our investment would be reasonable subject, of course, to whether such payout is consistent with the 40 percent limitation of the purchase agreement.

2.(a) We have analyzed Conrail's financial projections, including traffic, earnings and cash flow, as well as the projections of the United States Railway Association and the figures of Morgan Stanley.

(b) The proposed dividend yield is higher than for other railroads based solely upon the proposed purchase price of $48 per share for Conrail's stock and the current market prices of other railroad stocks. However, the dividend payout ratio anticipated is a fairly conservative distribution of the projected earnings and cash flow of Conrail. We would expect dividends to increase as Conrail's earnings increase, and, of course, decrease if earnings are not up to the level which has been forecast.

2. (c) We have not given consideration to making additonal investments in Conrail. We would have to consider all the attendant factors and circumstances in the event additional sums are needed at that time.

(d) We do not expect Conrail to have to make up cash deficit given the flexible response of Conrail to business cyclicality under current management. However, with a modest level of long term debt with respect to its rolling stock, Conrail has a number of options for raising money it might need, including passing a dividend, borrowing money or offering additonal stock.

3. We anticipate joining with others in the Investor Group to offer part of our investment to the public from time to time depending upon Conrail's financial status and market conditions.

4. (a) We are advised that a copy of our commitment letter has been made available to the Committee.

(b) We have no intention of pulling out of the Morgan Stanley proposal and are fully prepared to join with others in the Group to make the purchase of Conrail stock. There are the usual conditions in the commitment letter that are somewhat formalistic but we assume that those conditions will be met if the Congress approves the proposal. As the investment adviser and manager of mutual funds with over $24 billion in assets, we made our commitment on the basis of a thorough and thoughtful review of the Morgan Stanley proposal and we are anxious to meet our commitment.

(c) The legal technicalities of the commitment letter aside, as a matter of business policy and to preserve our reputation and good will in the market place, we would never lightly refuse to honor our commitment.

(d) We have no knowledge of what other investors would do but we do understand that Morgan Stanley can readily obtain other investors.

We appreciate the opportunity to give you our views. We feel strongly that the Morgan Stanley proposal is a good one and will be favorable to all concerned, particularly the officers and employees of Conrail, its shippers and The United States Government.

Sincerely,

JOSEPH S. DIMARTINO,
President and Chief Operating Officer.

FAYEZ SAROFIM & CO.
Houston, TX, July 11, 1985.

Senator JOHN C. DANFORTH,
Committee on Commerce, Science, and Transportation,
Washington, DC.

DEAR SENATOR DANFORTH: This letter is in reply to your letter regarding our participation in the Morgan Stanley investor group.

We feel Conrail offers us an attractive investment opportunity over a 3 to 5 year time horizon. We see a company with excellent management strong cash flow, and reasonably well-maintained capital plant. We expect that the public market will recognize Conrail's value over time, allowing it to achieve capital gains as a result of the gradual distribution of the common stock from the investor group to the public. We expect dividends as a percentage of net income to be in the 35–45 per cent range. Such a payout would be comparable to other railroad companies. We believe this level of dividends would be appropriate relative to net income, cash flow, and capital needs. We have reviewed Conrail's financial projections and find them reasonable. We recognize, however, the possibility of a shortfall. Depending on its severity and duration we would expect dividends to be cut or eliminated in order to maintain the capital plant. In the event further capital was required we would anticipate, depending on the circumstances, either an infusion of new equity from the current investors or the public on the floatation of some debt securities or some combination of the above. We have the resources to commit additional capital to Conrail in the future and would do so if our evaluation at the time suggested that it would be a profitable opportunity.

We expect that we will still have significant holdings in Conrail for the indeterminant future. We expect, however, to gradually reduce our holdings over the first two to three years as we feel it important that there be a public market for Conrail's equity securities in order to establish some liquidity and to establish a public market value for the company. Market conditions will obviously dictate the speed and extent to which our position is reduced, but our investment is based on the assumption that it will be a long-term investment.

We consider our commitment to Morgan Stanley and the investor group to be iron-clad. In our firm's 27 year existence, we have never reneged on such a commitment. Assuming that the structure of the Conrail sale is not radically altered, we consider our only option to be that of honoring our commitment of $30 million. The commitment is well within our resources under any circumstances and we will honor it. We do not know what legal recourse Morgan Stanley has against us if we did not honor this commitment. We do not have any obligation to "make up the difference" if another investor in the group chooses not to fulfill this commitment and are not aware of any investor who would be willing to cover our commitment if we reneged, although we are aware of other investors who, at the current time, have expressed an interest in investing who are not members of this group.

I hope this letter addresses your questions and concerns. Please do not hesitate to call if further clarification is required.

Sincerely,

FAYEZ SAROFIM.

FISHER BROS.,
FINANCIAL & DEVELOPMENT CO.,
New York, NY. July 11, 1985.

Hon. JOHN C. DANFORTH,
Chairman, Committee on Commerce, Science, and Transportation, 497 Russell Senate Office Building, U.S. Senate, Washington, DC.

DEAR MR. CHAIRMAN: Thank you for giving us the opportunity to respond to the "Questions For The Investors" which is attached to your letter to us dated July 2, 1985. Our responses to those questions are numbered numerically and alphabetically in the same order as the "Questions For The Investors" attached to such letter dated July 2, 1985.

1a. After reviewing Conrail's performance for the last few years and based on our experience in investing in public and privately held companies, it is our belief that Conrail will be a viable and profitable company.

1b. Based on projections and our analysis, we would expect to receive a highly competitive 10% return on our investment.

2a. We have carefully analyzed Conrail's financial projections with respect to traffic, earnings and net cash flow.

2b. While the initial yield may be in excess of the current dividend yields of other major railroads, when the stock of Conrail will be fully distributed the yield will be competitive with the yields of other major railroads.

2c. & d. While we do not anticipate that it will be necessary to invest additional sums in Conrail to make up any cash deficit, if such additional sums are required, we would expect to be able to use the capital markets to obtain any such additional sums.

3. It is impossible to be able to determine at this time how long we would hold our stock interest in Conrail, but as you have been advised by Morgan Stanley, it is expected that the investors are looking at a commitment of up to 5 years.

4a. We have been advised that you have a copy of our commitment letter indicating its terms.

4b. c. & d. We have made a serious commitment to Morgan Stanley to invest in Conrail and we would expect to honor that commitment. In fact, one of the primary reasons that we joined the Morgan Stanley group is the quality of that investor group consisting of sophisticated investors who, like ourselves, are well-known for honoring their commitments.

If you have any questions, please feel free to call or write.

Very truly yours,

RICHARD L. FISHER.

THE GOTTLIEB CORP.,
Kansas City, MO, July 22, 1985.

JOHN C. DANFORTH,
Chairman, Committee on Commerce, Science, and Transportation, 428 Hart, U.S. Senate, Washington, DC.

DEAR SENATOR DANFORTH: In response to your letter and questions of July 2, 1985 my answers are contained below:

1a. Based on Morgan-Stanley's advice we consider Conrail a good investment opportunity.

1b. No direct expectation of a specific amount. The Morgan-Stanley proposal does contain such projections and are considered by this writer as part of any ultimate return.

2a. No. Relied on Morgan-Stanley projections.

2b. N/A.

2c. This seems such a highly unlikely event when you consider managements ability to reduce or even pass dividends to cover any short term cash flow problem that no such considerations have been made or contemplated.

2d. See 2c.

3. This is unknown at this time due to the uncertainty of when Morgan-Stanley would be able to complete their initial public offering and thereafter the risks of market timing.

4a. We have been advised you are now in possession of a copy of the Morgan-Stanley commitment letter. This letter speaks for itself.

4b. Our understanding in this regard is contained in the commitment letter identified in 4a above. It should be noted however, that we have been and continue to pursue getting into this transaction not out of it.

4c. This is a legal question I'm not qualified to answer. It is our intention to honor this commitment and while I can not speak for Morgan-Stanley I'm certain they will honor theirs.

4d. Not to my knowledge.

Very truly yours

ARVIN GOTTLIEB, *President.*

COLUMBIA UNIVERSITY IN THE CITY OF NEW YORK,
OFFICE OF INVESTMENTS,
New York, NY, July 22, 1985.

Hon. JOHN C. DANFORTH,
Chairman, Committee on Commerce, Science, and Transportation, 497 Russell Office Building, U.S. Senate, Washington, DC.

DEAR SENATOR DANFORTH: Thank you for your letter of July 2, 1985 and list of questions concerning the proposed Morgan Stanley group investment in Conrail.

The questions in many ways are not really consistent with the investment process used by Columbia in evaluating a proposed investment, but I will answer them in general terms.

1. Columbia is willing to invest in this proposal because on balance it appears to offer a long-run total rate of return that is suitable at acceptable levels of risk. Dividends would parallel those of other railroad stocks over a long period of time.

2. Projections are only a part of any investment decision. We feel that a financially revitalized Conrail, in which the employees already hold a significant interest,

should be a very competitive long-term investment, especially given the location of its markets.

3. We would hope to hold an investment in Conrail for a long period of time, understanding that we may be required to sell a portion of it to a broader group of investors in the future.

4. It is my understanding that all the commitment letters have been made available to the Committee. In answering the subquestions I will simply say Columbia intends to honor its commitment and follow through should the proposal come to fruition, unless some material changes were made in the proposal which would alter substantially the investment risks involved.

If you or any member of your Committee would like to discuss this further, we would be more than happy to meet with you.

Sincerely,

CHARLES G. DYER,
Vice President for Investments.

HARBERT CORP.,
Birmingham, AL, July 8, 1985.

Hon. JOHN C. DANFORTH,
U.S. Senate, 497 Russell Senate Office Building,
Washington, DC.

DEAR SENATOR DANFORTH: I have received your letter of July 2nd enclosing questions from the Senate Committee on Commerce, Science, and Transportation about my company's involvement in the Morgan Stanley proposal to purchase the Government's 85 percent interest in Conrail.

When Morgan Stanley first approached us in April, 1985, we were not particularly interested, being skeptical of a major investment in any railroad. Because of past experience, we have always been concerned about railroads' labor problems; inefficient work practices; poor utilization of equipment; and the ever increasing costs of track and roadbed maintenance. In addition to these concerns, we were, of course, cognizant of Conrail's unknown political ramifications from pending decisions, the results of which could not be evaluated. At first glance, I would have given 20 to 1 odds against the possibility that Morgan Stanley could even get a hearing in Washington after Secretary Dole's decision was announced.

While in New York on May 2nd, I met with Morgan Stanley representatives and received two sets of documents outlining their proposal to a select group of potential investors. I studied these carefully on the plane trip home, and the next day, I asked three knowledgeable members of my staff, on whose judgment I rely when making investment decisions, to study the documents and evaluate all aspects of Conrail's operations: financial projections; cash flow; potential profits; operating problems; labor problems; management capabilities; comparison to and competition with other railroads in their peer group. We even considered what might happen to Conrail in the event of a major military conflict.

Our conclusion was that the Morgan Stanley proposal offered an attractive investment opportunity. The downside risk was minimal when compared to the upside potential. On Friday afternoon, May 3rd, I called Tom Saunders, Managing Director of Morgan Stanley, and told him we thought the proposal had merit, that we would continue to study it over the weekend, and would give him a commitment the following week. On Wednesday, May 8th, we telecopied our Letter of Intent, committing $50,000,000 to the investment opportunity. At that time, we expressed an interest in increasing our participation to $100,000,000; I believe you have a copy of our June 7th Letter of Intent which verifies this commitment.

With regard to your questions about Conrail dividends, we did not become involved in this proposal because of the anticipated dividend income; indeed, there are far more lucrative investments than Conrail if our interests were simply annual dividends. We are looking for maximum enhancement of our investment dollar. We believe that the maximum return will come from the long-term financial viability of Conrail. In our opinion, Morgan Stanley's projection for dividend yields is conservative and is in line with that of other major railroads.

If there should be a shortfall in Morgan Stanley's projections, we are prepared to make available additional funds as conditions warrant. Our review of the Conrail projections indicates that Conrail has the cash flow, assets and potential earnings power to support additional debt, if necessary. We recognize that portions of stock will be sold in an orderly fashion to the investing public over a period of time, but

we plan to hold the stock until we are able to maximize both its value and our return on investment.

I am somewhat puzzled by the tone of your questions about members of the investment group "pulling out." My company has been in business almost 40 years, and we have never failed to live up to a contract or commitment. Our June 7th Letter of Intent denotes that our commitment "will terminate on December 31, 1985, unless extended in writing by the undersigned." That means that we are obligated to keep $100,000,000 available for the sole purpose of investing in Conrail until December 31st, and I have no reason to believe that the termination date would not be extended if necessary. These funds cannot be used for any other purpose, and we—and all other members of the investor group—realized this when we became involved. An early resolution of the issue would enable all of us to put our committed funds to other uses.

Harbert has earned a reputation for honoring commitments and for responding in a timely manner; therefore, we are offered attractive proposals on a daily basis. I can assure you that we never would enter a proposition if we thought legal recourse against the lead investor were a possibility. I never even considered the subject until I read your question. I recognize that one or two investors, for reasons beyond their control, might have to withdraw from the group, but I am confident that we and other members would be willing and certainly able to make up any additional funds necessary.

We feel that the Morgan Stanley proposal is a sound investment to those involved; it provides a service to the Government by offering an alternative to the Norfolk Southern Corporation's bid; and it eliminates the antitrust complications which are inherent to the Norfolk Southern proposal, thereby avoiding what I am sure will be numerous and costly lawsuits.

I hope I have answered your questions. I will be glad to come to Washington for further discussions if it will be helpful.

Sincerely,

JOHN M. HARBERT III,
Chairman of the Board.

Boston, MA, July 11, 1985.

Hon. JOHN C. DANFORTH,
Chairman, Committee on Commerce, Science, and Transportation, 497 Russell Senate Office Building, U.S. Senate, Washington, DC.

DEAR MR. CHAIRMAN: As you requested, we have forwarded the attached responses to your questions regarding the Conrail transaction.

Sincerely,

DONALD D. BEANE.

RESPONSES TO QUESTIONS

1a. Harvard believes that the market value of Conrail will in time be higher than the price being paid for the property. This judgment is based on a comparative review of Conrail's current and prospective earnings, cash flow and assets relative to competitive rail transport businesses. As such, we believe that the investment will enhance the University's total return.

1b. Based on the Morgan Stanley material, we expect annual dividends of $4.20/share.

2a. Harvard has thoroughly reviewed Conrail's business plans.

2b. We believe that Conrail can maintain the projected dividend. Our analysis, however, does not conclude that the yield is far in excess of other railroads', when one compares the dividend to a reasonable public market price for Conrail shares. On this basis, we estimate the market yield to be 6 percent, not measurably distant from CSX's 4 percent and NSC's 5 percent.

2c. and d. If the projections are not realized, we would expect that the dividend would be reduced, instead of making a cash call on the owners. Further, to the extent that the cash flow of the business declined in any very major way, we would expect that Conrail would use its significant borrowing capacity to generate cash not to pay dividends, but to continue to maintain and enhance its physical plant.

3. Harvard has no set timetable for holding investments, but rather makes decisions based on its continuing evaluation of comparative values. Presuming that pricing is favorable, Harvard expects to sell some of its holdings as Morgan Stanley conducts public offerings of the Group's shares. To the extent that the business contin-

ues to grow and generate increasing cash flow, it is likely that Harvard would continue holding its shares.

4a. Our commitment letter is conditional regarding confirmation of the facts presented regarding the operations of Conrail and final determination of price and other terms of the sale.

4b. If the terms of the transaction were altered prior to closing such that we no longer believe the investment to be attractive, we would be within our rights to withdraw. After closing, we have no rights to withdraw.

4c. We expect that any changes to the transaction would be subject of discussion with all parties and not cause for legal proceedings.

4d. We have no knowledge of specific contingency plans designed to cover withdrawals of members of the Group.

KR CAPITAL ADVISORS, INC.,
New York, NY, July 11, 1985.

Senator JOHN C. DANFORTH,
Chairman, Committee on Commerce, Science, and Transportation, Room 497—Russell Senate Building, Washington, DC.

DEAR SENATOR DANFORTH: KR Capital Advisors is pleased to respond to your questionnaire regarding our participation in the Morgan Stanley led investor group to purchase Conrail from the United States government. As investment advisors, our clients expect us to invest in securities that we believe offer attractive returns and limited risk vis-a-vis other stock market alternatives. Our investment style frequently leads us to situations that could be regarded as out of the "main stream" of investment opportunities when compared to most money managers. Accordingly, we feel an investment objectives and philosophy.

Based on Morgan Stanley's analysis, we believe Conrail will pay approximately $120 million worth of dividends annually to the shareholders. Naturally, we consider this an expectation, not a guarantee, and we are therefore prepared to accept the risk of a potential dividend cut or elimination. Of course, the current financial condition of Conrail as measured by liquidity and debt/equity ratios indicate that Conrail is financially healthy and has the ability to maintain the suggested dividend. Although yield at purchase will be high when compared to other railroad issues, we expect that over time the security will appreciate and bring the yield in line with comparable companies.

It is our understanding that if Conrail continues to live within the requirements of the Public Interest Covenants, the company is unlikely to become so financially impaired that it could not have access to the same normal financing sources that other corporations use to make up short-term cash deficits. As is the case with all of our investments, we would weigh our options if Conrail would fall back into financial crisis. In that case, we would have to consider such factors as the amount of additional commitment required, the available investment monies at our disposal and, of course, the interests of our investors.

We have always aimed to optimize investment returns for our clients and always try to dispose of shares on an orderly basis. In that light, we are comfortable with the requirement that the investment group resell its shares to the public within the established five-year period.

It is our understanding that your Committee has a copy of our commitment letter which indicates the terms therein. If this is not the case, we would be pleased to provide you with another copy. KR Capital and its principals have a long-standing and solid reputation in the financial community. We are familiar with the use of commitment letters in the early stage of an investment transaction and most certainly recognize our obligation to act responsibly. Certainly, the Committee understands that Wall Street operates in a very competitive environment where intergity, good judgment and reliability are essential to continued success. We will continue to live by these standards which we consider our most valuable assets.

We have had no discussions with the other investors but are aware of their excellent investment reputations. In no instance are we aware of any requirement to make up the difference if we, or any of the investors, pull out. However, we have been advised by Morgan Stanley that the proposal has been oversubscribed and therefore would expect any shortfall to be easily made up.

I hope these comments help satisfy your need to know the intent and role of members of the investment group. We, of course, would be pleased to respond to additional questions or provide any other information that you may require.

Sincerely,

KR CAPITAL ADVISORS, INC.
JOHN B. RYAN, *President.*

GILMARTIN, POSTER & SHAFTO,
New York, NY, July 16, 1985.

Hon. JOHN C. DANFORTH,
U.S. Senate, Committee on Commerce, Science, and Transportation, 497 Russell Senate Office Building, Washington, DC.

DEAR SENATOR DANFORTH: Mr. George S. Livanos, who resides abroad and is presently travelling, has asked me to respond on his behalf to your letter to him dated July 3 concerning the Morgan Stanley proposal to purchase Conrail. It was impossible for him to comply with your request for a response by the close of business on July 12 because your letter did not reach him until this past weekend. To avoid further delay, he has asked me to respond to you directly. I have, of course, discussed the response with him by telephone before forwarding it to you.

Basically, the Livanos interests desire to invest in Conrail because they believe this will be a good investment, i.e., that the prospect for financial returns is reasonable compared to the risks inherent in the investment. The investor recognizes that no investment is risk-free, but considers that the results achieved by the existing Conrail management team and Conrail's existing asset base give a good foundation for future Conrail success.

Before making the commitment, Mr. Livanos considered the financial data furnished by Morgan Stanley and consulted with his advisors. Those reviews, and subsequent discussions with other persons knowledgeable about the rail transportation business, led to the conclusion that an investment in Conrail would generate sufficient returns over time as to make it a reasonable investment for the Livanos Group.

The primary focus in making the investment is not dividend income. While the investor believes the Morgan Stanley projections with respect to dividends are reasonable, it is also recognized that any business is subject to the vicissitudes of business cycles, general business recessions, and other matters which can not be foreseen. However, the Livanos Group also believes that a sound business can and will attract whatever financing may be necessary to see it through cyclical downturns and in this regard is prepared to accept the possibility that the dividend flow may not be as presently projected if that turns out to be the case. Declaration of dividends will be the province of the Board of Directors of Conrail, and given the stature of the participants in the Morgan Stanley group, it is certain that the Board eventually chosen will be composed of persons well aware of their responsibilities to run the business in a sound and prudent fashion.

With respect to your question about the length of time the Livanos interests will hold the investment, no decision has been made, nor can one be made now. Any businessman continually reviews his investment portfolio in the light of changing world situations, economic conditions, and other related factors. It is an on-going process. All that can be said now is that Mr. Livanos has no difficulty with the provisions of the Morgan Stanley proposal for a sale to the public of a percentage of Conrail, and that the balance of the shares has to be considered to be essentially a long-term holding.

We understand that you have seen the form of commitment letter signed with Morgan Stanley. No consideration has been given to "pulling out" of the proposal. The commitment is valid until December 31, 1985, by which time is is hoped that Congress will have decided the fate of Conrail. There is a possibility that Congress, in the enabling legislation, may place conditions or restrictions on the sale of Conrail which were not envisioned at the time the commitment was made. We, of course, will want to review the enabling legislation to see how, if at all, it changes the premises on which the commitment was made. The Livanos interests value their reputation for keeping their commitments. They do not believe that the question of "pulling out" can even arise unless the circumstances under which the United States ultimately agrees to dispose of Conrail do not reflect the basic assumptions underlying the Morgan Stanley proposal, which we understand are similar to the basic assumptions of competing proposals.

Finally, you ask if Mr. Livanos would be prepared to make up the difference if other investors "pull out". While it is possible that an investor may for some reason have to withdraw from the Morgan Stanley group, the reputations of the participants for integrity and seriousness is outstanding, so there is no concern on the part of Mr. Livanos that any participant will not fully honor the commitment made. Further, we know that several investors have already indicated a desire to increase the amount of their commitment and Mr. Livanos therefore has a high degree of confi-

dence that the full amount necessary to fund the Morgan Guaranty proposal will be readily available. Were the Livanos interests to be offered the opportunity to increase the amount of the commitment they have made, they would certainly be willing to consider doing so.

I trust the above answers your inquiries. I would mention one other factor which seems relevant, although not specifically addressed in your questions. Given the serious nature of the commitment and the substantial sum involved, funds have been set aside to make the investment as promptly as the completion of formalities allows after Congress has acted. The use of this capital for any other purpose other than short-term investments is thereby effectively foreclosed to the investor pending the outcome of the Conrail situation. One of the biggest concerns at least some of the participants in the Morgan Stanley proposal have is that the enactment of the legislation that is required for any sale of Conrail by the United States will be indefinitely delayed. It is therefore hoped that for the best interests of the United States and all concerned a decision will be made as expeditiously as possible.

Very truly yours,

PATRICK J. GILMARTIN.

THE METROPOLITAN MUSEUM OF ART,
New York, NY, July 10, 1985.

Senator JOHN C. DANFORTH,
U.S. Senate, Committee on Commerce, Science, and Transportation, Washington, DC.

DEAR SENATOR DANFORTH: I am happy to respond to your letter of July 2nd, directed to each member of the Morgan Stanley investor group, in which you ask a series of questions. I will answer in the order presented.

1a. We are investing in the Morgan Stanley proposal to purchase Conrail because we believe that the railroad is viable and offers at least as great an opportunity for total return at no greater risk as other investments in our endowment.

b. Depending on the railroad's ability to pay, we anticipate a dividend of $4 per share. As with stock companies, we realize that the Board has the right to set the dividend rate and we understand there is no guarantee that we will receive the dividends that are indicated in the proposal.

2a. Yes.

b. We feel that Conrail can afford to pay the proposed dividends. Once the market has priced the stock competitively to other eastern railroads, the yield rate will be in line with other eastern railroads.

c/d. This investment represents the Museum's largest single external commitment in its endowment. We have a policy which precludes holding more than 10% in any one investment. We would consider investing additional funds as our endowment grows, but the market place, as the stock is transferred to the public, should provide liquidity, as is the case with any other viable, publicly traded stock.

3. We expect to hold Conrail stock as long as the potential value in a relative sense is more attractive than alternate investments in the open market.

4a. Commitment letter (See attached copy.)

b. We have no option to pull out of the investor group before the sale unless the terms of the proposal have changed. After the closing on the sale, we understand that there might be an opportunity to have one of the other investors acquire our portion, as long as no one owned more than 10%, but that is not our intention.

c. We have entered into this agreement with the other investors with the full moral commitment of our Board. In its more than 100 year's, the Metropolitan Museum has never reneged on a commitment.

d. We have no knowledge of other investors being required to cover our position should we pull out, because we have no intention to do so and the topic has never been brought up to us.

Sincerely,

JAMES Q. GRIFFIN.

NOMURA SECURITIES INTERNATIONAL, INC.,
New York, NY, July 11, 1985.

Senator JOHN C. DANFORTH,
U.S. Senate, Committee on Commerce, Science, and Transportation, Washington, DC.

DEAR SENATOR DANFORTH: In reference to your questionaire regarding Nomura Securities' participation in the Morgan Stanley proposal to purchase Conrail, we have prepared the following answers:

(1a) Nomura Securities believes that the Morgan Stanley proposal to purchase Conrail from the government offers an attractive investment opportunity.

(b) Based on projections by Morgan Stanley, Conrail will pay approximately $121 million in dividends per year which on a per share basis (assuming the $48 share price) represents a yield of about 10%.

(2a) We have analyzed Conrail's financial projections internally. As a result of this careful consideration of the underlying financial assumptions, we believe that Conrail offers an excellent investment opportunity.

(b) The underlying reason for our investment in Conrail is our belief in the economic viability of Conrail. As a result, we believe that it will be able to pay dividends as projected. Based on our comparison of Conrail's dividend payout ratio with that of other railroads, we do not feel the projected dividends are excessive.

(c) Based on our fundamental analysis of Conrail, we do not anticipate any capital shortfalls in the future that would necessitate additional capital contributions by the investors. Thus, we do not plan to invest additional funds at this time. However, should additional funds be necessary, we will make our decision to commit additional funds at that time based on analysis of the situation and all possible financing options.

(d) As a private corporation with a strong balance sheet, Conrail will have a wide range of financing options, should additional funds be required.

(3) Nomura intends to realize a profit on our investment in Conrail as soon as we feel it financially prudent to do so.

(4a) As stated in the commitment letter, Nomura Securities has agreed to purchase $70 million worth of Conrail's stock at $48 per share, subject to the four stated conditions. The agreement will be in effect until December 31, 1985, and we intend to honor our commitment until that time.

(b) We have not analyzed our options for "pulling out" because we intend to honor the terms of commitment with Morgan Stanley.

(c) We are neither aware of any or have explored what legal recourse that Morgan Stanley may have against us.

(d) As we understand the situation, the Conrail proposal has been substantially oversubscribed, therefore, making up the difference would probably not be a problem. But, since we intend to honor our commitment, the issue is, in effect, moot.

Should you need additional information or have follow up questions, please contact my associate Donald Rigoni at (212) 208-9370, or me.

With best regards,

HITOSHI IMUTA,
Senior Vice President, Investment Banking.

NYNEX CORP.
White Plains, NY, July 9, 1985.

Hon. JOHN C. DANFORTH,
Chairman, Committee on Commerce, Science, and Transportation, 497 Russell Senate Office Building, U.S. Senate, Washington, DC.

DEAR MR. CHAIRMAN: As requested, attached are NYNEX's responses to the questions posed in your letter of July 2, 1985.

I want to emphasize that we continue to have a strong commitment to participate in the Conrail investment.

If your staff has any questions, please contact Mr. Harvey Leong on 914-683-2150.

Sincerely,

W.G. BURNS,
Vice Chairman and Chief Financial Officer.

Enclosure.

RESPONSES TO QUESTIONS

1a. It is our belief that

Conrail would be a sound investment and provide a premium rate of return over more typical readily marketable investments.

The current management team has shown the ability to manage an efficient railroad operation.

Conrail is currently well positioned in the railroad business.

The right conditions would be in place to operate as a viable and profitable stand-alone business.

1b. The current expected amount is some $2.45 million annually. We expect the firm to prosper in the future, and dividends to grow over time along with earnings. Our expectation of potential capital appreciation is an important element of the investment decision however.

2a. Yes. We find them to be reasonable and exhibiting prudent business assumptions.

2b. Conrail's payout of dividends, as a percent of earnings and cash flow, are conservative based on comparison with other railroads. The dividend yield is a result of the stock offering price. We would expect the marketplace, in the future, to bid up the stock price based on earnings prospects. As a result, dividend yield would come into line with other railroad stocks.

2cd. Currently, the financial projections appear to be reasonable. (If indeed, financial projections do not materialize, there are action steps available to the Board of Directors and management team.) As to additional investments, these decisions would be made in light of the specific circumstance and prudent investment judgments.

3. Our intentions are to continually review market conditions and determine whether to hold or relinquish this investment.

4a. Our commitment is subject to the passage and signature into law of appropriate legislation to authorize the transaction, a satisfactory arrangement with Conrail's Agreement Employees, an effective registration statement, the negotiation of the definitive purchase agreement with the U.S. Department of Transportation as set forth in the Morgan Stanley & Co. Invitation to Investors dated April 18, 1985, lack of any material adverse changes, and approval by our counsel and Board of Directors. The Commitment is for the period until December 31, 1985.

4b. We have signified a strong intent to participate based on circumstances as we now understand them. Should they change dramatically, we would have to re-evaluate our decision. After the closing, we will continue to monitor our investment in light of market conditions. We will have options to make sales among shareholders and transfers to affiliates.

4c. It is our intent to honor the commitment letter in accordance with its terms.

4c. Our commitment is made as an individual corporate investor and governed by the terms set forth above. We have no obligations to make up differences for parties which withdraw.

COMMONWEALTH OF PENNSYLVANIA
PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM,
Harrisburg, PA, July 11, 1985.

Hon. JOHN C. DANFORTH,
Committee on Commerce, Science, and Transportation,
U.S. Senate, Washington, DC.

DEAR SENATOR DANFORTH: I am in receipt of your letter dated July 2, 1985 to Mr. James A. Perry, Executive Director of the Pennsylvania Public School Employees' Retirement System. What follows is my response to your questions as the retirement system's Investment Administrator.

1a. Given the facts that surround the proposed price to assets, the capability of existing management to produce a solid operating profit, the company's proposed capitalization, and the company's market share of rail traffic in the mid-Atlantic industrial and commercial base, I feel Conrail offers an attractive investment opportunity on a value based analysis. Additionally, such an investment also allows the system to protect and enhance it many investments in the Commonwealth of Pennsylvania.

1b. For the purpose of analysis of potential returns to the retirement system, a 10 percent rate in dividends was assumed. Such an assumption recognizes that in an operating environment, dividends can be increased as well as decreased, subject to operating performance. The rates on dividends as well as the potential price earnings multiple were sensitized to indicate the various possibilities of return to the retirement system.

2a. Yes. Given Morgan Stanley's due diligence, and Conrail's assessment and experience in dealing with past economic operating environments, I believe there is more than sufficient operating information to make informed financial judgments regarding the company's future operating performance.

2b. Under the terms of the Morgan Stanley proposal, the transaction is essentially an all-cash purchase. With debt to total capitalization just 17 percent, this previous statement is hardly out of order. Furthermore, given the enhancements already made to rolling stock, other equipment, and road bed, any significant capital re-

quirements to plant and equipment other than normal maintenance and replacement cannot be construed as an overhanging problem. Therefore, considering these facts, as well as the overall payout ratio, I believe it realistically possible that such a yield can be met.

Dealing with the issue of affordability of dividends involving comparisons with other operating railroads, any examination must also consider and compare total cost of capital, which includes histories of operating managements and results, leverage involving the company's capital structure and its tax picture to reveal any potential for overpricing of capital. Furthermore, given the re-emergence of Conrail as a possible independent operating company, there would be a normal assessment of risk premium to the cost of capital.

2c. This question presupposes that Conrail as an independent entity would not have recourse to financing from anywhere outside the investor group. Highly unlikely, given the capitalization of the company and its earnings history.

Are there instances, even at this premature stage, where additional financing would be considered by the retirement system? Yes. Perhaps through equipment trust certificates.

3a. The retirement system considers itself a long-term investor.

4a. This retirement system has signed a firm letter of intent to commit $25,000 toward the purchase of Conrail. The commitment is subject to normal contingencies involved in such an investment.

4b. For the first part of this question, I would refer you to the answer concerning the nature of the retirement system's commitment. Regarding the second part of the question, much of what you asked is covered under article I, paragraph 2.06 of the shareholders' agreement and article III of the same agreement.

4c. The retirement system regards its commitment as a firm one.

4d. More appropriately referred to Morgan Stanley.

Senator Danforth, I hope my response on behalf of the retirement system's sincere interest towards purchasing an investment in Conrail is of help to you.

Sincerely,

CLAY B. MANSFIELD, *Investment Administrator.*

T. ROWE PRICE ASSOCIATES, INC., INVESTMENT RESEARCH AND COUNSEL,
Baltimore, MD., October 7, 1985.

Hon. JOHN C. DANFORTH,
Chairman, Committee on Commerce, Science, and Transportation, 497 Russell Senate Office Building, U.S. Senate, Washington, DC.

DEAR SENATOR DANFORTH: We appreciate the opportunity to respond to the questions presented in your letter of July 2, 1985. As you know from our testimony before the Senate Committee on Commerce, Science and Transportation, we are an independent investment counsel firm. Our client, the Board of Pension Trustees of the Delaware State Employees Retirement Fund, requested that we conduct an analysis of Conrail and evaluate the merits of an investment in Conrail. We were also requested to follow and manage their investment in Conrail if one was made. Our answers to specific questions are as follows:

1a. Our analysis of Conrail as an independent corporation showed to us that Conrail was a viable investment appropriate to a long term investor.

1b. Our initial expectations of dividends to be paid is approximately $4.00 per share which is equivalent to an 8.33% yield on the initial $48 per share investment.

2a. Several of our people have done an analysis of Conrail's financial projections. We have an experienced staff in basic industry investments, including railroads. We concluded that Conrail is a viable, stand alone corporation.

2b. We believe that Conrail can afford to pay the dividends projected in the Morgan Stanley analysis. While the yield on the forecasted stock price of $48.00 per share is above other railroads, the payout of forecasted earnings and cash flow is in line with other appropriate and necessary on this security given the risk of illiquidity and uncertainty of the timing of public offerings assumed by the investor group.

2c. We believe that even if Morgan Stanley's financial projections are not met, Conrail will not endure a cash deficit of any magnitude. We would be prepared to take steps which might be appropriate to protect and enhance our initial investment, including additional investment subject to our and our client's analysis and circumstances at that time.

2d. Conrail might make up a temporary cash deficit by a variety of means, including adjusting dividends, capital expenditures, etc.

3. Our investment in Conrail will depend upon market conditions and the vote of the investor group regarding stock sales.

4a. We have attached a copy of the commitment letter.

4b. Our commitment to make an investment in Conrail is a firm one. The commitment letter outlines our options for withdrawal before closing. Once the sale is made, we will own the Conrail stock.

4c. We do not know whether Morgan Stanley has any legal recourse against us. Our commitment to invest in Conrail is a firm one.

4d. It is our intention to make the Conrail investment. We have had no discussions with others regarding their assuming our commitment.

We are happy to have been of assistance in this matter.

Sincerely,

GEORGE A. ROCHE, *Vice President.*

BECK, MACK & OLIVER,
New York, NY, July 10, 1985.

JOHN C. DANFORTH,
U.S. Senate, Committee on Commerce, Science, and Transportation, Washington DC.

DEAR SENATOR DANFORTH: I am responding to your letter of July 2, 1985 to Carl Schafer, Financial Vice President of Princeton University. I am Chairman of the Investment Subcommittee of the Princeton University Board of Trustees.

Answers to your questions are as follows:

1a. Princeton is investing in the Conrail proposal because the proposal appears to offer a "premium" rate of return contra other, like, investment alternatives.

b. Princeton expects dividends will be paid up to the maximum allowable payout (40%) whenever company earnings, cash flow and internal fund requirements allow.

2a. Yes.

b. The Conrail projections appear to allow the payment of dividends up to the maximum allowed without impairing the financial condition of the Company nor curtailing the proposed capital programs.

c. Yes.

d. Not applicable.

3. Princeton expects to held its Conrail investment until such a time as the confluence of company earnings prospects and stock market price suggests to us that all or part of our position be sold. We can afford to hold this position for many years if earnings prospects and Conrail market price suggest we do so.

4a. I believe a copy of the full commitment letter has been made available to the Committee.

b. The agreement permits investors to withdraw if there are any "significant" changes in the proposed purchase terms. Unless there are radical changes proposed, Princeton is highly unlikely to withdraw its investment interest.

c. I would expect so.

d. I believe that there are investor dollars committed to this propsoed purchase ($1.5 billion) in excess of the proposed purchase price ($1.2 billion). The withdrawal of Princeton's $20 million commitment would, it seems, be easily met from these "oversubscription" funds.

Respectfully,

JOHN C. BECK.

SOROS FUND,
New York, NY, July 26, 1985.

Senator JOHN C. DANFORTH,
U.S. Senate, Committee on Commerce, Science, and Transportation, Mailroom SD508, Washington, DC 20510.

DEAR SENATOR DANFORTH: I would first like to apologize for the delay in my response which was due to a heavy travel schedule.

We are investing in the Morgan Stanley proposal as we have a long-standing history of investing in railroads and believe that Conrail represents an attractive opportunity. Insofar as the dividend is concerned we would expect a comparable dividend policy to that of other large railroads.

We have analyzed Conrail's financial projections and maintain a constant review and analysis. In light of these projections we believe that the company can support the estimated dividend policy.

We do not believe that it will be necessary to invest additional sums, therefore we have not considered this alternative. Should Conrail have to make up a cash deficit, we feel there are other means available to a company of that size and stature to raise additional capital.

We are prepared to hold our stock interest in Conrail as long as it is necessary to realize reasonable rates of return on our investment. We understand that the terms of our commitment are on file in your office; and as long as there are no material changes we stand by that commitment.

In answer to questions 4c and d, not to our knowledge.

We believe we have sufficiently answered the questions, however, should you wish to reach us, please feel free to call.

Sincerely,

WILLIAM A. EHRMAN.

ROSEWOOD FINANCIAL, INC.,
Dallas, TX, July 11, 1985.

Hon. JOHN C. DANFORTH,
Chairman, Committee on Commerce, Science, and Transportation, 497 Russell Senate Office Building, U.S. Senate, Washington, DC.

DEAR MR. CHAIRMAN: We appreciate the thoughtful deliberations that you and the Committee are undertaking in connection with the disposition of the Conrail system and are hopeful that this letter will assist you during the course of your deliberations.

In connection with our participation in the Morgan Stanley proposal to purchase Conrail, our analysis indicates to us that Conrail has sufficient strength to remain an independent entity and that as a public company its ability to access capital markets should enhance its long term viability. We view our investment in Conrail the same as any other investment and in making this investment decision, as others, we try to learn as much about a company as the size of the investment merits, giving due consideration to its long and short term potential. Any future decisions concerning Conrail will be determined by our outlook for the industry, the economy and the company at such time as the question arises.

A review of the proposed dividend policy indicates to us that it is well within the range of dividend payout ratios of most large railroads and, thus, should not prove to be detrimental to the long term viability of Conrail as an independent railroad and to us as an investor. We view a comparison of Conrail's yield to the yield of other large railroads to be not entirely appropriate since other large railroads are more broadly diversified and the initial price of Conrail will reflect the existence of a large supply of stock to be sold in the future.

It is my understanding that Morgan Stanley has provided you with a copy of our letter to them concerning this matter, which answers any questions regarding its terms and conditions.

We thank you and the Committee for your time in considering this letter and the Morgan Stanley proposal.

Sincerely,

MARK W. HOBBS, *President.*

SPEARS, BENZAK, SALOMON & FARRELL, INC.,
New York, NY, July 31, 1985.

Senator JOHN C. DANFORTH,
Senate Committee on Commerce, Science, and Transportation,
U.S. Senate, Washington, DC.

DEAR SENATOR DANFORTH: Attached is the response of our firm, Spears, Benzak, Salomon & Farrell, Inc., to your questionnaire concerning our prospective investment in Conrail. I'm sorry we are so delayed in our reply, but we never received your original letter. Sherman Joyce forwarded a copy to us, and I am replying via the attached set of responses.

I hope our answers will be helpful in connection with the Committee's review of the Morgan Stanley proposal. We believe the investment provides an excellent opportunity, and would be happy to amplify on our thinking in any manner that might be useful to you.

Sincerely,

RICHARD E. SALOMON.

P.S.—Jack McAtee has been a good friend for years. He's spoken highly of you on many occasions. I hope our paths might cross in person sometime soon.

Enclosure.

RESPONSES TO QUESTIONS

1a. We have analyzed Conrail from the point of view of its attractiveness relative to other eastern railroads. It appears to have a more conservative capitalization and, under the terms of the Morgan Stanley proposal, our purchase would be at a considerable lower valuation than the other railroads. We feel, moreover, that Conrail's management has proven very strong and that the company's plant and equipment is modern and well maintained.

1b. We anticipate dividend payouts consistent with those of other major eastern railroads. Morgan Stanley has forecast total dividends in the range of $118 million annually, or approximately $4 per share. At approximately 37 percent of forecast earnings, this would be in line with other railroads. However, as with any investment, we understand that these dividend forecasts are not guaranteed and may be lower or higher depending on the company's performance and the decisions of the Board of Directors.

2a. Yes, we have carefully reviewed information made available by Morgan Stanley and other sources. We believe that Morgan Stanley's projections are reasonable.

2b. The proposed payout of dividends by Conrail as a percentage of earnings and cash flow are in line with other major railroads. A comparison of dividend yields to the initial stock price is not a reasonable measure in this case, as we fully expect the marketplace to bid up the stock price once the stock is fully distributed as a result of a public offering. At that time, we expect Conrail's dividend yield to come into line with other railroad stocks.

2c&d. Based on Conrail's recent performance as well as future projections, we do not anticipate that the company will face cash deficits. However, should this occur, we would have to evaluate our position in light of the specific circumstances. Given Conrail's relatively conservative financial structure (low debt-to-equity ratio), additional contributions from investors would very likely be only one of a number of responses which would be available to Conrail's Board of Directors in the event of a cash shortfall. We have every expectation that Conrail will have full access to national and international capital markets to meet its financial needs.

3. We have not yet decided. As with any other investment, our decisions will be guided by market conditions and other factors.

4a. We understand that a copy of our commitment letter to Morgan Stanley has already been made available to the Committee on a confidential basis.

4b&c. We remain committed to the purchase of Conrail under the terms of the Morgan Stanley offer and have no intention of pulling out. The form of our commitment is common within the financial community and was entered into in good faith based on careful analysis of both the opportunities and risks of the investment. Our business reputation rests on honoring our commitments. Of course, if the terms of the offer are substantially changed as a result of the legislative process, we would reserve the right to re-evaluate our decision.

4d. Although we do not expect any of the other investors to fail to honor their commitments, we understand that Morgan Stanley has been over subscribed and that additional investors would be prepared to step forward should the need arise.

KAUFMAN AND BROAD, INC.,
Los Angeles, CA, July 15, 1985.

Hon. JOHN C. DANFORTH,
Chairman, Committee on Commerce, Science, and Transportation, 497 Russell Senate Office Building, U.S. Senate, Washington, DC.

DEAR MR. CHAIRMAN: We are pleased to respond to the Committee's inquiries concerning our proposed investment in Conrail through a group organized by Morgan Stanley. This letter will supplement the detailed information concerning the proposal that was supplied by Morgan Stanley in testimony before the Committee and in a letter dated July 1, 1985 which accurately reflect our understanding of the economics of the transaction.

Kaufman and Broad is a New York Stock Exchange listed holding company with substantial interests in housing and life insurance. Our company maintains a close relationship with several major investment banking firms in order to be made aware of investment opportunities. These firms know of our willingness to commit our resources to viable operating businesses with the support of management in

order to earn a fair return over a period of years. Morgan Stanley approached us in this spirit with respect to Conrail and, after studying the data presented to us, we agreed to make an equity investment.

We reached several conclusions after reviewing Morgan Stanley's projections. First and foremost, we believe that Conrail will be a viable long-term operating company and that mangement will be able to increase productivity of the rail system. Second, it is our view that as a successful operating company, Conrail will generate sufficient cash flow to cover dividends and that the payout ratio after a short time will be comparable to that of other railroads as a result of an increasing share price and cash flow. Finally, we expect to resell our Conrail shares to the public within five years, at which time we will realize a fair return on our investment for assuming the market risk and for having provided the capital necessary to transfer to the investing public an operationally and financially stronger entity than we purchased.

We understand that Morgan Stanley provided the Committee a copy of our commitment letter last month. We consider the letter typical of those entered into in investment transactions of this sort. Our subsidiary holding company signed the letter in good faith on the basis of conditions existing at the time and would fully expect to honor the commitment if the business, financial and legal aspects of the transactions are not materially altered prior to the time of closing.

I hope that the foregoing is responsvie to your inquiry.

Very truly yours,

ELI BROAD, *Chairman.*

TAUBMAN INVESTMENT CO.,
July 11, 1985.

Hon. JOHN C. DANFORTH,
U.S. Senate, Committee on Commerce, Science, and Transportation, Washington, DC.

DEAR SENATOR DANFORTH: We appreciate your letter of inquiry regarding our proposed investment in Conrail, and welcome the opportunity to elaborate on our thinking with respect to this decision, since it is a matter for both public policy consideration and private sector financial analysis.

The first group of questions you have raised, numbered one and two, deal with our financial review of Conrail and our expectations regarding its financial performance, with special emphasis on our view of its ability to pay dividends. We have of course reviewed the financial projections made by Morgan Stanley, and our conclusion that the potential financial rewards were reasonable in light of the risks being undertaken by the investor group was the basis for our decision to participate in the group.

In business, as in politics, there is of course no certainty, and we do not expect that the projections we examined exactly predict the future course of events. We expect, given the sophistication of our fellow investors, that decisions regarding dividends and financing will be made intelligently, on a prudent basis, and with due regard for conditions at the time.

It is our experience that the depth and flexibility of the American financial markets are such that any profitable or prospectively profitable business opportunity is always able to attract the capital needed to fund itself. We think the track record of Conrail over the past years clearly suggests that it represents a profitable business opportunity, and we are quite certain that under the continued stewardship of its existing management, with the support and guidance of the investor group, it will continue to be able to finance itself and, if appropriate, prudently pay dividends. While we therefore do not expect our willingness to invest additional sums to be tested, we obviousy would have an incentive to do so if it became necessary.

With respect to your third question, we have made no firm decision with respect to the period of time we would expect to hold this investment, since any decision would in any event have to be revisited in light of subsequent developments. However, we are quite comfortable with the restrictions placed upon our ability to resell as a part of the Morgan Stanley group, as it is generally our view that Conrail has more upside opportunity as an investment than it does downside risk, a condition under which some illiquidity is acceptable.

With respect to your fourth question regarding the terms of our commitment, a copy of our letter to Morgan Stanley is enclosed for your information. Our understanding is that Congress may well change the terms of the transaction from those that were envisioned when the commitment letter was signed, and that under those circumstances we would of course have an opportunity to revisit our decision to

invest. Other than that, we expect to keep our commitment, and cannot envision circumstances under which Morgan Stanley would have need of the courts in order to get us to honor it. With regard to the last issue you raised, we cannot speak for other investors, but we would certainly consider raising our commitment if others pulled out, and have so indicated to Morgan Stanley.

We appreciate being asked for our views on this proposal. We would like to observe in closing that financial considerations were not our sole criteria for the investment decision, although they were paramount. It is also our view as citizens and taxpayers that the decision to sell to Norfolk Southern, regardless of its merits at the time it was made, is clearly no longer the right decision given the availability of the Morgan Stanley proposal. We urge you and your colleagues to move quickly to accept this alternative in the public interest.

Sincerely,

BERNARD WINOGRAD.

UNITED STATES STEEL AND
CARNEGIE PENSION FUND, INC.
New York, NY, July 10, 1985.

Hon. JOHN C. DANFORTH,
Chairman, Committee on Commerce, Science, and Transportation, U.S. Senate, Washington, DC.

DEAR SENATOR DANFORTH: We have received your letter of July 2nd and are pleased to submit herewith our replies to the questions you asked of investors with respect to the Morgan Stanley Proposal to purchase Conrail from the U.S. Government.

Sincerely yours,

JOHN G. VAN DEUSEN,
Senior Vice President.

Attachment.

ANSWERS TO QUESTIONS

1a. We believe Conrail stock at the proposed purchase price is good value and that the investment can earn us an attractive profit.

1b. The Morgan Stanley projections suggest a Conrail dividend payment of $118 million which does not seem unrealistic. Our 1.77% share is estimated at approximately $2,100,000.

2a. Yes.

2b. The projections would seem to support the aforementioned dividend expectation. We think dividend yields on other railroad stocks largely reflect the market's evaluation and that the matter of affordability is virtually unrelated to market yield.

2c. We would need to know what caused the unexpected shortfall. We could not now commit to a further investment.

2d. That also would seem to depend on what caused the shortfall. However, we see no basis for believing that Conrail would not also have access to conventional capital markets.

3. Until it no longer is attractive compared with our investment alternatives or until someone else values the stock more highly than we.

4a. The terms are as stated in our letters dated May 2, 1985 and June 6, 1985, copies of which are enclosed.

4b. Our options for "pulling out" prior to closing are as indicated in the commitment letter. We are not aware of how one "pulls out" after closing.

4c. If the conditions of the commitment letter are met in full, it is inconceivable that we would refuse to make the investment.

4d. We have no information on this point.

EZRA K. ZILKHA,
New York, NY, July 11, 1985.

Hon. JOHN C. DANFORTH,
U.S. Senate, Committee on Commerce, Science, and Transportation, Washington, DC.

DEAR SENATOR DANFORTH: Thank you for your letter of July 2nd regarding the Morgan Stanley proposal to purchase Conrail from the U.S. Government. I will reply to the questions which you have asked in the best way I can.

I'm intending to invest in this transaction because it presents a sound investment opportunity, and in regard to the dividends, I expect that the railroad will be able to

pay dividends that are consistent with other railroads but subject to the limitations of the Purchase Agreement. I have analyzed the financial projections, earnings and net cash flow, and I believe that the railroad can pay dividends that are consistent with other major railroads.

As to investing further amounts, since this situation is not anticipated at the moment, I have not come to a decision on that, but I would evaluate it in light of the projections and the situation of the capital markets.

I have not made up my mind as to how long I would hold my stock interest in Conrail.

A copy of my commitment letter has been made available to you by Morgan Stanley. The commitment was made by me in good faith in light of circumstances as they exist at this time.

It is customary in business to make commitments of this sort, and I fully hope and expect that the transaction will materialize. I do hope that I have answered your questions.

Yours sincerely,

EZRA K. ZILKHA.

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